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UNIVERSITY OF ALBERTA

Economic Analysis in Canadian Tax Cases

by

Berry Fong-Chung Hsu

A THESIS

SUBMITTED TO THE FACULTY OF GRADUATE STUDIES AND RESEARCH

IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE DEGREE

OF

MASTER OF LAWS

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Abstract

The application of economic theories, rightly or wrongly, has a major impact on our lives. Economic reform inevitably leads to political reform. However, much remains unanswered about whether economic reform leads to reform in the judicial decision making process. Although there are a number of studies on the economic analysis of taxation, that is, the study of economics and tax policies, there is virtually no literature on the economic analysis of tax cases. The time is apt to study the connection between economic analysis and case law in taxation as Canada approaches the twenty-first century. This thesis investigates whether the Supreme Court of Canada has taken economic reality into consideration in making its decisions on tax matters. It is the first attempt to address the issue. Although it is somewhat exploratory and speculative, it is a starting point.

Firstly, the background of Canadian tax policies is discussed, with special emphasis on the Carter Commission, which, as we shall see, had a lasting influence on contemporary Canadian tax policies. Secondly, the relevance of law and economics is discussed with special emphasis on the use of economic tools to analyse common law cases. From these discussions, we shall try to link the theories of

economics to tax cases, as no literature has addressed such a topic. Thirdly, we shall analyse the trend of applying economic analysis in federal tax cases before we conduct our final analysis of Supreme Court tax cases. We believe the Supreme Court tax cases are an important yardstick as they are not only precedent-setting, but often trend-setting. Although the lower level courts are bound by the *ratio decidendi* of the Supreme Court cases, they are not bound by the general tendency of the Supreme Court.

We make no assumption that there is an absence or presence of economic reality in the Supreme Court tax cases. This will be addressed in our analysis before we draw our conclusions. With the foregoing analysis, we hope to provide a final analysis of the reasons behind the absence or presence of economic reality in Supreme Court tax cases.

The law is stated as at 9 April 1992.

Berry Fong-Chung Hsu
Edmonton, Alberta
23 April 1992

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I. Introduction

The *Arthurs Report*[1] raised a few issues in legal scholarship. It called for changes in traditional Canadian legal education in order to encourage more fundamental research. In the area of tax law, we have to examine how it is made and administered, its impact on our economy and on our political and social life, and its cultural significance. The judicial decision making process in tax law is an area which is under-researched.[2]

Canadian tax scholarship tends to assume that the legal reasonings provided by the judiciary determine the outcome

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[1] *Law and Learning: Report to the Social Sciences and Humanities Research Council of Canada* (Ottawa: Minister of Supply and Services, 1983).

[2] Almost twenty years after the publication of the *Arthurs Report*, journals dedicated to fundamental research have finally made an inroad into the Canadian academic world. For example, the Can. J. of Law and Society, the Can. J. of Legal Studies, the Can. J. of Family Law, and the Can. J. of Women and the Law. These journals are edited by faculty boards rather than by the traditional student-controlled law review boards. The growing amount of interest in fundamental research in Canada has raised a question as to the boundaries between the legal scholar's study of the tax law and the work of sociologists, economists, or political scientists writing about tax law. See Neil Brooks, "Future Directions in Canadian Tax Law Scholarship" (1985) 23:3 Osgoode Hall L.J. 441 at 444.

Canadian legal scholarship, however, has been dedicated mostly to the area of doctrinal scholarship. A survey of Canadian law journals has revealed that tax law research in Canada focuses mostly on treating taxation as a set of rules and delineating what it is. See Brooks, op.cit., pp.445-446. This type of scholarship, however, is an important contribution by legal scholars to the professional community. It has been observed that tax law scholarship in Canada takes on formalism seriously. See Brooks, op.cit., p.453.

of cases, and that judicial decision making is neutral and largely autonomous.[1] Legal scholars in Canada seldom use any of their research on legal interpretation to inquire into the systematic methodology of the courts.[2] An integration of doctrinal and fundamental research can be used to examine the extent to which economic reality[3] affects the judicial decision making process.

A. Background

Before examining the extent to which economic considerations affect the judicial decision making process, we shall first briefly discuss the development of Canadian tax policy. The economic objectives of Canadian tax policy are full employment, economic growth, and stable prices, which have been addressed in the *Carter Report*.[4] The burden of the judiciary in deciding our economic prosperity depends on the extent to which tax policy shapes our economy. The

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[1] See Brooks, op.cit., pp.453-454.
[2] Brooks, op.cit., p.454.
[3] The term "economic" will be discussed further in Chapter II. "Reality" here refers to a real thing, fact, or state of things. Economic reality encompasses *inter alia* economic analysis and economic approach. In an economic analysis, economic methodologies and theories are being applied. The economic methodologies and theories can be used by the courts in the judicial decision making process or can be used to analyse the case decided by the court. In an economic approach, the results reported by economists are accepted by the courts without the necessity of applying any economic methodology or theory.
[4] *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1966).

greater the role played by tax policy, the heavier the burden on the judiciary, as it is their role to interpret tax legislation.

The Development of Canadian Tax Policy

Although the scope of this thesis will be limited to judicial interpretation of federal income tax legislation, we shall provide an overall scenario of the use of taxes in public finance in Canada. The intention of any tax policy is to raise money to support governmental policies. In the old days, its main usage was to construct public utilities, support the civil service, and maintain national security. Over time, taxes have been employed to achieve the social goals of the government of the day. As economic theories develop, so do tax policies. The use of tax policy to advance horizontal and vertical equities among the citizens of the land is a modern-day concept which was unknown when tax was first imposed in Canada.

In 1650, the first recorded tax was imposed in Canada.[1] The tax was on the export of beaver and moose pelts, and the estimated revenue raised was less than $200. Prior to 1867, the major source of tax was tariffs. Since

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[1] J. Harvey Perry, *Taxation in Canada* (Toronto: Canadian Tax Foundation, 4th edn. 1984), p.17; See generally Vladimir Salyzyn, *Canadian Income Tax Policy* (Don Mills: CCH Canadian Ltd., 5th edn. 1990), pp.37-38.

the enactment of the *British North America Act* by the British Parliament in 1867, the federal government has been granted very wide power to impose any taxes.[1]

From 1867 until the First World War, excises on spirits and tobacco were raised by the government. During this period, for reasons unknown to tax historians, personal property was defined in most statutes to include "income" for the purpose of municipal taxation.[2] In 1850, income was first taxed to some extent in Ontario.[3] In 1876, provincial income tax was also imposed by British Columbia,[4] and, in 1894, by Prince Edward Island.[5] In 1913, corporation and personal income taxes accounted for a mere 8.1 per cent of all provincial government revenue.[6]

In 1917, the first federal personal income tax legislation was enacted as the *Income War Tax Act*. This was the first direct taxation ever imposed by the federal government in order to finance the heavy expenditures incurred by the First World War. According to statistics, between 1915 and 1920, $1,120 million was collected in taxes

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[1] Section 91 of the *Constitution Act*, 1867 (U.K.), 30 & 31 Vic., c.3.
[2] J. Harvey Perry, *Taxes, Tariffs, & Subsidies: A history of Canadian fiscal development* (Toronto: University of Toronto Press, 1955), p.80.
[3] Perry, *Taxes, Tariffs, & Subsidies*, p.83.
[4] Perry, *Taxes, Tariffs, & Subsidies*, p.75.
[5] Perry, *Taxes, Tariffs, & Subsidies*, p.121-122.
[6] Perry, *Taxes, Tariffs, & Subsidies*, p.123.

and 85 per cent of that sum came from custom and excise taxes. This became a new model for provincial income tax statutes.[1]

In the 1920s, there were changes in the weights for provincial personal income taxes. In 1925, Manitoba allowed the federal income tax as a deduction and provided an allowance for children.[2] In the same year, provincial income tax rates were reduced in British Columbia.[3] In 1927, Prince Edward Island raised its exemptions.[4] However, at the same time most provinces increased their corporation taxes.[5] The general levy at any rate was at most 2 per cent.[6] In 1926, the federal income tax underwent a major revision and the rates were reduced, and substituted by one single schedule of graduated rates, running from 2 per cent on the first $2,000 to 50 per cent on income over $500,000.[7]

During the 1920s, the provincial governments also introduced motor vehicle licences, gasoline taxes, and liquor profits, and municipal governments increased their revenues through property tax to finance increasing public construction and expanded social security programs.[8] In

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[1] Perry, *Taxes, Tariffs, & Subsidies*, p.230.
[2] Perry, *Taxes, Tariffs, & Subsidies*, p.232.
[3] Ibid.
[4] Ibid.
[5] Perry, *Taxes, Tariffs, & Subsidies*, p.233.
[6] Perry, *Taxes, Tariffs, & Subsidies*, pp.233-234.
[7] Perry, *Taxes, Tariffs, & Subsidies*, p.219.
[8] Perry, *Taxes, Tariffs, & Subsidies*, p.227.

1922, a gasoline tax was first introducted in Alberta at the rate of 2 cents per gallon.[1] After Prohibition, provincial governments took over the monopoly sale of liquor and as a result liquor sales became a major revenue source.[2]

In the 1930s, tax rates increased substantially and Alberta introduced a provincial income tax. By 1930, corporation and personal income taxes accounted for 26.5 per cent of the total provincial taxes.[3] By 1939, with the exception of Nova Scotia and New Brunswick, all provinces levied personal income taxes.

In 1937, the Royal Commission on Dominion-Provincial Relations (the Rowell-Sirois Commission) was appointed. In 1940, it made its recommendations on various aspects of federal-provincial fiscal relationships. The Commission concluded that income tax should be used as the "equalizer and chief instrument of adjustment in the whole tax system" to finance social programs.[4] It also took the view that a unified control of tax collection would reduce the cost of tax collection and enhance efficiency. Accordingly, it recommended that the provinces and municipalities should withdraw from the personal income tax field. It also

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[1] Perry, *Taxes, Tariffs, & Subsidies*, p.228.
[2] Ibid.
[3] Perry, *Taxes, Tariffs, & Subsidies*, p.238.
[4] Royal Commission on Dominion-Provincial Relations, *Report*, Book II, (Ottawa: Queen's Printer, 1940).

recommended the complete withdrawal of provinces from the corporation tax field in order to make good the inequity, lack of uniformity, and lack of efficiency arising from the divided jurisdiction. The Commission also made other recommendations to enhance the efficiency of tax collection. Not only did it consider inheritance tax an unsatisfactory source of provincial revenue, it thought that the federal government was in a better position to monitor people who would try to escape liability from inheritance taxes by establishing domiciles overseas.

World War II was about eight times as expensive as World War I, and it was essentially financed by tax revenues, mainly income taxes. According to statistics, personal income tax collections increased more than sevenfold between 1939 and 1942 and almost doubled by 1944. Similarly, in 1944 corporate income tax revenues were almost six times the amount they had been in 1939. In 1939, the federal government's share of total tax revenues was 44 per cent. In 1944, it was 82 per cent.

After World War II, the federal government's share of taxes gradually dropped to the 50 per cent range. In 1945, income taxes formed about 7 per cent of the Gross National Product. This increased to 12 per cent in 1970 and reached 20 per cent in 1990. The *Income War Tax Act* was originally

introduced as a temporary measure but it remained in effect until the end of 1948 as amended. In 1949, the *Income Tax Act* was in operation. This *Act* reworded and resconstructed the tax statute, and introduced the current system of capital cost allowances using the diminishing balance method, a dividend tax credit, and an inexpensive appeal system. It also eliminated most of the discretionary powers of the Minister of National Revenue under the previous legislation. The powers of the Minister included administrative and punitive matters, being the judge of reasonableness or equity and of facts, and granting or refusing exemptions and allowances.[1]

The *Income Tax Act* of 1962 was "the product of half a century of improvisation, and ..... had left its mark."[2] Changes in the economic, social and political climate led to the creation of the Royal Commission on Taxation in 1962. Most of its recommendations were expected to bring the Canadian tax system in line with a modern society.

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[1] J. Richard Petrie, *The Taxation of Corporate Income in Canada* (Toronto: University of Toronto Press, 1952), p.88.
[2] J. Harvey Perry, "Background and Main Recommendations of the Royal Commission on Taxation" in Neil Brooks ed., *The Quest for Tax Reform: The Royal Commission on Taxation Twenty Years Later* (Toronto: Carswell, 1988), p.24.

The Economic Objectives of Canadian Tax Policy

Historically, governments of Canada took a market approach in their economic policy. The economic objectives were to balance the budget and to interfere as little as possible.[1] The Great Depression in the 1930s made government intervention necessary, and that role has been expanded during the post-war period. John Maynard Keynes (1883 - 1946), a British economist, provided the theoretical framwork for this new role which has been diminishing in recent years.[2] The application of Keynesian doctrine in Canada can be seen with the use of the tax system to regulate the private economy and investment, to provide incentives to certain sectors, and to finance social security programs since the Second World War.[3]

Economists take the view that since no person would want to pay taxes, governments should expect opposition to any taxes they impose.[4] The imposition of taxation is therefore a balancing act in politics and the government of the day would attempt to minimize its political cost.[5]

In addition, various factors leading to the present Canadian tax policy include "special interest groups, the

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[1] Perry, *Taxation in Canada*, p.7.
[2] Ibid.
[3] Ibid.
[4] Salyzyn, op.cit., p.38.
[5] See Les MacDonald, "Why the Carter Commission Had to Be Stopped" in *The Quest for Tax Reform*, pp.351-363.

media, bureaucracies, national emergencies, tax illusions, the constitution, the budgetary process, the tax collection system, intergovernmental relations, and experiments with taxes in other countries."[1] The enactment of tax legislation is the ultimate product of compromises among these various factors. As tax policy affects almost every citizen of the land, the survival of the government dictates that it must be politically acceptable. The judiciary would have a difficult task in interpreting an unpopular tax statute; more so, if it is politically sensitive.

According to the *Carter Report*,[2] most Canadians would prefer a tax policy which would: (1) maximize the present and future output of goods and services; (2) distribute goods and services equitably; (3) protect liberties and rights of individuals; and (4) maintain and strengthen the Canadian federation. After analysing research on "basic values, explanations of private sector economic behaviour, and the nature of public choice, and by relying on empirical judgments based on observed degree of political and ethical acceptance prevalent," Vladimir Salyzyn has concluded that these social goals of Canadian tax policy amount to a consensus among the population.[3]

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[1] Salyzyn, op.cit., pp.38-48.
[2] Vol. 2, p.7.
[3] Salyzyn, op.cit., p.16.

However, the question is whether the government can, through taxation, redistribute income using the above criteria. This has raised substantial debate among economists. There is no simple way to create a tax base that can achieve economic efficiency, justice, and individual rights and freedom.[1] In Canada, the tax base is aiming at the social goal of "opportunities and power".[2] The *Carter Report* recommended that the economic power of a taxpayer should be his net income from all sources and all forms less non-discretionary uses of that income.[3]

The Carter Report

The *Carter Report* has generally been regarded to have a high scholarly standard and is highly praised internationally.[4] The recommendations of Kenneth Le M. Carter and the extent of their implementation by the federal government have been topics of much academic writing and we do not intend to repeat these discussions here.[5]

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[1] R.W. Tresch, *Public Finance: A Normative Theory* (Plano, Texas: Business Publications, 1982), p.270.
[2] J. Rawls, *A Theory of Justice* (Cambridge, Mass.: Belknap, 1971), p.60; Salyzyn, op.cit., p.27.
[3] Salyzyn, op.cit., p.27.
[4] Brooks, *The Quest for Tax Reform*, p.6.
[5] For examples, see Brooks, *The Quest for Tax Reform*. However, it is worthwhile to note that since the publication of the *Carter Report*, tax scholarship has been developed significantly and has increased in sophistication both theoretically and empirically. Brooks, *The Quest for Tax Reform*, p.19. Some of the techniques not availabe at the time of Carter have shed new light on some of the analyses

Doubts have been expressed as to whether Canadian tax policy would be worse had there been no recommendations made by Carter because the Carter Commission was born at a time of prosperity and political parties were vying to offer various welfare policies.[1] The social and economic environment in the 1960s was regarded as one of "collective euphoria."[2] The difficult economic times in the 1970s and the 1980s have reversed this euphoria. In 1960, 33 per cent of Canadians filed tax returns and only 25 per cent of Canadians paid income taxes.[3] In 1980, the figures are 60 per cent and 40 per cent respectively. The need for simplicity and equity in the tax system is greater than ever.[4]

As to the efficiency of the Canadian tax system, critics suggest that it has been emphasized at the expense of equity.[5] Regarding the achievement of vertical equity, recent scholarship has shown that major developments in incidence theory and significant empirical work might put

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[5](cont'd) by the Royal Commission.

[1] Douglas G. Hartle, "Some Analytical, Political and Normative Lessons from Carter" in *The Quest for Tax Reform*, pp.397-400.

[2] Hartle, op.cit., p.400.

[3] See Roger S. Smith, "Base Broadening and Rate Changes: A Look at the Canadian Federal Income Tax" (1984) 32:2 Can. Tax J. 277.

[4] Ibid at p.292.

[5] Ibid at p.401; For a discussion of efficiency and equity, see A. Mitchell Polinsky, *An Introduction to Law and Economics* (Boston: Little, Brown and Company, 1983), pp.110-113.

the evidence for a rate structure on progressive taxation in doubt.[1] The Carter Commission accepted property taxes to be regressive; sales tax, at best, to be proportional; and corporate taxes to be borne mostly by consumers and workers,[2] but these views have been contested by the new views on the incidence of property, sales and excise, and corporate income taxes.[3] For example, according to the new view that saw part of the property tax as profits tax, property taxes were found to be progressive throughout most income classes.[4]

In Canada, several Royal Commissions have examined the issues relating to the equity and efficiency of the tax system.[5] However, the starting point should be the *Carter Report*. Although only some of the features recommended by Carter were eventually enacted into the federal *Income Tax Act*, it has provided a blueprint and a source of debate for the future of taxation of income in Canada.

The *Carter Report* called for the preservation of representative and responsible government. Unfortunately, 24 years after its release, the legislative process behind the

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[1] Roger S. Smith, "Rates of Personal Income Tax - The Carter Commission Revisited" in *The Quest for Tax Reform*, p.174.
[2] Ibid at pp.175-176.
[3] Ibid at pp.177-187.
[4] Ibid at p.175.
[5] See e.g., *Report of the Royal Commission on Dominion-Provincial Relations* (Ottawa: Queen's Printer, 1954).

enactment of fiscal legislation is still shrouded in secrecy. Submissions to the government of the day are still made on an individual basis behind closed doors. Only a small group of civil servants and Cabinet ministers may review the proposed budget.' Members of Parliament and even government backbenchers have little feedback.

There does not seem to be a concern by any government of the day to provide to the public opportunities to make their views on tax law known to their Members of Parliament. One can rightly suspect that such law only reflects the values of a few elite groups. In other areas of law, there is usually a consultative process before enactment is made. The Alberta Law Reform Institute has constantly solicited public opinion before making recommendations on proposed legislative changes to the government.

Another issue is how tax law should be administered. The *Carter Report* recommended better protection of the liberties and rights of the individual taxpayers. Tax law should be clear and avoid complexity and should be fully and consistently enforced. There are appeal processes, *Information Ciruclars*, *Interpretation Bulletins*, and Advance Rulings provided by Parliament and the government. In

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' Tax Legislative Process Committee, "The Tax Legislative Process" (1978) 26:2 Can. Tax J. 163-164.

Nowegijick v. Her Majesty the Queen,[1] the Supreme Court held that administrative policy and interpretation are not determinative but are entitled to weight and can be an important factor in case of doubt about the meaning of the legislation. In 1985, Revenue Canada issued the *Declaration of Taxpayer Rights* as a set of guidelines to ensure that taxpayers are dealt with fairly and impartially. Unfortunately, this has no legislative effect. Revenue Canada has available all the legal experts and resources required to make a law-abiding taxpayer bankrupt.[2]

Notwithstanding the apparent effort to implement the recommendations of the *Carter Report*, Section 245 of the present *Income Tax Act*[3] provides that if a transaction is an avoidance transaction, the tax consequence will be determined as is reasonable in the circumstances so as to deny the tax benefit that would otherwise result from the transaction.[4] The onus apparently is on the taxpayer to

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[1] [1983] 1 S.C.R. 29-42.

[2] e.g. Sections 224 and 225, *Income Tax Act; Information Circular No.75-16R*. For example, see "Harsh tax collection gets N.S. doc absolute discharge" The Lawyers Weekly, 14 September 1990; Barry K. Grossman, "Search and Seizure Under the Income Tax Act" (1987) 35:6 Can. Tax J. 1349-1383; R.B. Thomas, "Demand for Information Not A Violation of The Charter" (1990) 38:2 Can. Tax J. 372-374.

[3] R.S.C. 1952, c.148 as amended by 1970-71-72, c.63; and as subsequently amended.

[4] For a detailed analysis of this section, see Brian J. Arnold and James R. Wilson, "The General Anti-Aviodance Rule - Part 1" (1988) 36:4 Can. Tax J. 829-887; "The General Anti-Avoidance Rule - Part 2" (1988) 36:5 Can. Tax J. 1123-1185; Howard J. Kellough, "A Review and Analysis of the

prove that the transaction is for a *bona fide* purpose.[1] Unfortunately, the Minister of National Revenue has not invoked this section to date, providing an opportunity for a court challenge.[2] It is, however, not that clear from the authorities whether it is a violation of the *Canadian Charter of Rights and Freedoms*.[3] Any tax-planning scheme in these days is uncertain until the effect of this general anti-avoidance rule is settled. This section was apparently enacted more for administrative convenience than for any other purpose.

Another area of legal scholarship is the impact of law upon our economic, political, and social life. The *Carter Report* emphasized the need to maximize the current and future output of goods and services and to maintain and strengthen the Canadian federation. The Commission was of the opinion that, according to the present state of knowledge, free market forces would be the best choice. The reforms in Eastern Europe and the former Soviet Union during the last three years reinforce Carter's statement although

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[4](cont'd) Redrafted General Anti-Avoidance Rule" (1988) 36:1 Can. Tax J. 23-78; David A. Dodge, "A New and More Coherent Approach to Tax Avoidance" (1988) 36:1 Can. Tax J. 1-22.

[1] *Johnson v. M.N.R.*, [1948] S.C.R. 486, [1948] C.T.C. 195, 3 D.T.C. 1182.

[2] A review of all Tax Court of Canada and Federal Court judgements since January 1988 in the QL system has confirmed this statement.

[3] Joel Nitikman, "Is GARR Void for Vagueness?" (1989) 37:5 Can. Tax J. 1409-1447.

the fruits have yet to be seen. The fiscal policy of the government should be to broaden the tax base, provide for full taxation on capital gains, and include gifts and inheritances in income on the basis that anything that increases an individual's or a family's capacity to command goods and services should be included in the tax base. Horizontal and vertical equity should be achieved.[1] The federal government can then transfer resources from rich to poor provinces.

Taxation on capital gains has been gradually phased in, from the tax on 50 per cent of capital gains in 1972 to 75 per cent in 1990. Although gifts and inheritances are still exempt from being taxed, the deemed disposition on *inter vivos* gifts and on death under Section 70 of the *Income Tax Act* have indirectly taxed capital gains on what in fact is capital transfer. However, recent research has shown that the rate structure for personal income tax does not follow the *Carter Report*'s recommendations for a progressive tax system; the rates under the present *Income Tax Act* are relatively higher for middle-income taxpayers than those recommended, but the rates for high-income taxpayers are

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[1] For a discussion of Carter's influence in achieving tax equity, see David Sewell, "Towards Longer Time Horizons in Personal Taxation" (1988) 26:2 Osgoode Hall L.J. 235 at 239-246.

regressive.[1]

In examining the cultural significance of law, the *Carter Report* recommends that families should be considered as taxable units.[2] It reflects the cultural attitudes towards marriage and the family and the economic reality that a couple living together incurs fewer expenses than two persons living separately. In this pluralistic and secular society, the institution of marriage is no longer as sacred as it was. Nevertheless, the traditional way of life is recognized to a certain extent.[3]

There is no longer a consensus on moral, religious or aesthetic ideals. When moral panic breaks out, law continues to be invoked as binding on everyone in society, whatever their beliefs.[4] However, investigation of tax law and social security law reveal that the family is constituted by legal structures external to it,[5] as the roles of the spouses are regulated by the law of the state with economic consequences.

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[1] Vladimir Salyzyn, "Designing an Optimal Personal Income Tax Rate Structure: Goals and Criteria" (1988) 26:3 Osgoode Hall L.J. 577 at 598-602.
[2] Jack R. London, "The Impact of Changing Perceptions of Social Equity on Tax Policy: The Marital Tax Unit" (1988) 26:2 Osgoode Hall L.J. 287-311.
[3] e.g. Paragraph 118(1)(a) of the *Income Tax Act*.
[4] Katherine O'Donovan, "Family Law and Legal Theory" in William Twining ed., *Legal Theory and Common Law* (Oxford: B. Backwell, 1986), pp.188-189.
[5] Ibid at p.192.

According to some jurists, law is a form of "social engineering" directed towards achieving social harmony.[1] There is evidence that Canadian tax policy attempts to achieve this objective in view of changing social values. Paragraphs 56(1)(c.1) and 60(c.1) of the *Income Tax Act* recognize the common law relationship for inclusion and deduction of maintenance payments. However, present cultural values are still not ready for homosexual couples; the *Income Tax Act* refers only to heterosexual couples.

B. Tax Law as an Autonomous Discipline

Taxation is a statutory field, and, hence its rules of law as discussed in conventional textbooks and law reviews are well settled and not as uncertain as other areas of law. However, the application of the *Canadian Charter of Rights and Freedoms* to taxation is still developing.

A remarkable number of articles in tax law are in the area of tax planning.[2] Once a taxpayer finds a loophole to avoid tax, the government can easily make good the defect before presenting its next fiscal bill. As mentioned, Revenue Canada has provided Advance Rulings services. These rulings are considered binding only in respect of the

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[1] Roscoe Pound, *An Introduction to the Philosophy of Law* (New Haven: Yale University Press, 1959), p.47.
[2] Brooks, "Future Directions in Canadian Tax Law Scholarship" p.446.

taxpayer to whom they are issued.[1]

In expounding tax statutes, a strict interpretation approach has been adopted in the common law tradition subject to modification.[2] The consequence is to strengthen the certainty of tax law. This evolution can be traced back to English jurisprudence. The strict interpretation rule in tax law was adopted by the British House of Lords in *Partington v. Attorney General*,[3] and was applied when the taxpayer was avoiding the tax that would otherwise be payable in *C.I.R. v. The Duke of Westminster*.[4] However, in *Furniss (Inspector of Taxes) v. Dawson*,[5] Lord Scarman said:

> "Whatever a statute may provide, it has to be interpreted and applied by the courts; and ultimately it will prove to be in this area of judge-made law that our elusive journey's end will be found."

This decision does not really support a strict interpretation approach, and the Supreme Court of Canada took the view that the *ratio decidendi* of *C.I.R. v. The Duke of Westminster* was "too deeply entrenched in our tax law for

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[1] *Information Circular No.70-6R*; David M. Sherman, *Income Tax Research* (Don Mills, Ontario: De Boo, 1989), pp.68 and 99-100.
[2] Vern Krishna, "Developments in the Law of Income Taxation: The 1985-86 Term" (1987) 9 Supreme Court L.Rev. 487-494.
[3] (1869-1870), L.R. 4 H.L. 100.
[4] [1936] A.C. 1, 19 T.C. 490, 51 T.L.R. 467 (H.L.).
[5] [1984] 1 All E.R. 530 (H.L.)

the courts to reject it in the absence of clear statutory authority."[1] The strict interpretation approach has been modified by Canadian tax courts to suit economic reality. In *Stubart Investments Ltd. v. Her Majesty the Queen*,[2] Justice Estey wrote:

> "Income taxation is also employed by government to attain selected economic policy objectives. Thus the statute is a mix of fiscal and economic policy. The economic policy element of the Act sometimes takes the form of an inducement to the taxpayer to undertake or redirect a specific activity."

Traditionally, law is an autonomous discipline in that it is a subject entrusted only to lawyers.[3] Tax law is becoming less autonomous. In addition to being a statutory law, it is an area that every taxpayer has to deal with. Economists have to study its feasibility and implications,

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[1] In *Stubart Investments Ltd. v. Her Majesty the Queen* ([1984] C.T.C. 294, 84 D.T.C. 6305 (S.C.C.)), the Supreme Court of Canada has rejected that the lack of a business purpose is a sufficient reason to ignore a legal effective tax planning. However, the possibility that some sort of business purpose test may still be relevant in interpreting a particular provision of the *Income Tax Act* is still left open. See T.E. McDonnell and R.B. Thomas, "The Supreme Court and Business Purpose: Is There Life After Stubart?" (1984) 32:4 Can. Tax J. 853 at 854.

[2] [1984] C.T.C. 294, 84 D.T.C. 6305 (S.C.C.) at pp.6321-6322.

[3] Richard Posner, "The Decline of Law as an Autonomous Discipline: 1962-1987" (1987) 100 Har. L.Rev. 762.

and accountants have to operate within its rules. In tax law, common law doctrines apply only in interpretation. The *Canadian Charter of Rights and Freedoms* has not had a demonstrable impact on the wide power of Revenue Canada under the *Income Tax Act*.

Although the courts have followed Section 12 of the *Interpretation Act*[1] and have provided a logical interpretation of the *Charter*, they appear to be reluctant to override a tax provision by virtue of the *Charter*.[2] A survey of all the constitutional challenges to the *Income Tax Act* up to 1990 has shown that out of 17 cases, including one search and seizure case,[3] the taxpayers have lost all but one in the courts.[4] The case in point is *Symes v. Her Majesty the Queen*,[5] an equality case, and the Federal Court of Appeal subsequently allowed the appeal of the Crown.[6] If the above figures are an indication, taxpayers are well advised to think carefully before considering similar litigation. Such an approach by the judiciary is not

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[1] This section provides that: "Every enactment is deemed remedial, and shall be given such fair, large and liberal construction and interpretation as best ensures the attainment of its objects. R.S., c.I-23, s.11."
[2] David W. Ross, "Constitutional Tax Cases" (1990) 3:1 Canadian Current Tax J1-J8.
[3] *R. v. McKinlay Transport Ltd.*, [1990] 90 D.T.C. 6243 (S.C.C.); R.B. Thomas "Demand for Information Not a Violation of the Charter" (1990) 38:2 Can. Tax J. 372-374.
[4] Ibid at J6-J7.
[5] [1989] 89 D.T.C. 5243 (F.C.T.D.).
[6] [1991] 91 D.T.C. 5397 (F.C.A.).

unexpected if economic reality is taken into account.

The results of a *Charter* violation simply mean that the government of the day may have to refund monies to a large number of taxpayers who are affected by the decision. In *Air Canada v. British Columbia*,[1] the Supreme Court of Canada held that the successful appellant, Air Canada, cannot recover the money paid by its passengers for the tax on alcoholic beverages as it was acting as an agent to collect it under the *Act*. It is economically unrealistic to return taxes previously paid. In some other areas, like criminal law, at most a few hardened criminals can get away on technicalities. In the area of tax law, a substantial section of the population might suffer as a result of the government's need for revenue to achieve its economic objectives.

Because of its statutory nature, the development of tax law is limited. Some authorities argue for the demise of the strict interpretation rule to allow room for expansion of the law.[2] However, tax law is a self-contained area. For example, it does not follow the traditional master and servant test developed in contract and tort laws in

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[1] [1989] 1 S.C.R. 1133.
[2] Vern Krishna, "Developments in the Law of Income Taxation: The 1985-86 Term" (1987) 9 Supreme Court L.Rev. 487-496; "The Demise of the Strict Interpretation Rule" (1986) 1:28 Canadian Current Tax J135-J137.

determining whether a taxpayer has entered into a contract of service or a contract for service.[1]

In some other areas, where common law has to fill in the gap, the tax court has its own judicial development. For example, it would look at what actually happens rather than the prescribed legal formalities in determining the "location" of the management and control of a corporation[2] and in distinguishing whether a profit is an ordinary income or a capital gain.[3] The equitable rule of estoppel is of no avail against the Crown as the taxpayers cannot reasonably claim to rely on the form as some sort of promise by the Crown.[4] This is one of the reasons why expert system developers consider tax law an easier field in which to advance their Artificial Intelligence theories since reasoning begins from explicit rules enacted by Parliament.[5]

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[1] *Boardman v. Her Majesty the Queen*, [1979] C.T.C. 159, 79 D.T.C. 5110 (F.C.T.D.); *Wiebe Door Services Ltd. v. M.N.R.*, [1986] 2 C.T.C. 200, 87 D.T.C. 5025 (F.C.A.).

[2] *Unit Construction Co. Ltd. v. Bullock*, [1959] 3 All E.R. 831, [1960] A.C. 351 (H.L.); *Sifneos v. M.N.R.*, [1968] Tax A.B.C. 652, 68 D.T.C. 522.

[3] *Regal Heights Limited v. M.N.R.*, [1960] C.T.C. 384, 60 D.T.C. 1270.

[4] It has been accepted by Canadian courts that the doctrine of estoppel may operate against the Crown. See *Grobowsky v. M.N.R.*, [1986] T.C.J. No.1, Action No.85-262 (UI).

[5] Anne von der Lieth Gardner, *An Artificial Approach to Legal Reasoning* (Cambridge: M.I.T. Press, 1987), p.5.

C. An Economic Approach

One important area for analysis is whether there is a tendency towards using the economic approach in judicial decision making.[1] A review of cases indicates the presence of both patent and latent approval of such an approach. For example, in *Stubart Investments Ltd. v. Her Majesty the Queen*,[2] the court made it clear that:

> "[w]ithout the inducement offered by the statute, the activity may not be undertaken by

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[1] The conflict between responsibility to legal professionals and intellectual creativity to the academic world has been experienced by most scholars of tax law. Legal scholars have strong affiliations with members of the legal profession and their research is often cited in memorandum of law and taken seriously by the judiciary. On the other hand, legal scholars have an obligation to their own academic community to take a critical approach to the system and to pursue the truth, e.g. whether there are any institutional limitations on judicial decision making in tax cases.

It was suggested in the *Arthurs Report* that "[t]here is an apparent tension between the human-intellectual goals of a law faculty and its professional-training activities." In fairness, it also stated that "law schools also encourage students to develop intellectual insights and, to some extent, to identify standards of reason, of justice, of effectiveness."

Although tax law is generally regarded as a practical subject, there is no reason why it cannot develop into a "new, more introspective personality." The academic study of its social and economic implications would humanize what was conceived as a purely professional topic for lawyers and accountants. At present, most of the research in these areas is conducted by economists.

In researching the economic aspect of Canadian tax law, the *Carter Report* marks a new era. It is the most comprehensive Canadian report addressing the relationship between economic, social, and political issues and revenue collection. Some of its recommendations have been accepted by the government of the day and some have been gradually phased in. For a detailed examination of the implementation of Carter's recommendations, see *The Quest for Tax Reform*.

[2] [1984] 84 D.T.C. 6305 (S.C.C.).

> the taxpayer for whom the induced action would otherwise have no *bona fide* business purpose..... At minimum, a business purpose requirement might inhibit the taxpayer from undertaking the specified activity which Parliament has invited in order to attain economic and perhaps policy goals."

In *Her Majesty the Queen v. Phyllis Barbara Bronfman Trust*,[1] the Supreme Court said:

> "Assessment of taxpayers' transactions with an eye to commercial and economic realities, rather than juristic classification of form, may help to avoid the inequity of tax liability being dependent upon the taxpayer's sophistication at manipulating a sequence of events to achieve a patina of compliance with the apparent prerequisites for a tax deduction."

Tax law is a set of rules used to enforce the economic and fiscal policy of the government of the day. The political ideology of the government in power would probably lead to changes in tax provisions in order to advance its political objectives. In theory the judiciary is

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[1] [1987] 87 D.T.C. 5059 (S.C.C.).

independent. In practice, judges come from different backgrounds, depending on the political party in power which appoints them. In any country, judicial decisions are inevitably affected by judicial ideology. There is ample research, both theoretical and empirical, to support this assumption.[1] However, studies have also shown that judges are not necessarily consistently liberal or conservative.[2] It would be interesting to investigate the role of the judiciary in interpreting tax statutes.

Judges are individuals who have their own predilections, prejudices and rational processes.[3] Research has shown that in important constitutional issues, the justices of the Supreme Court of Canada have camouflaged their political calculations under the guise of legal reasoning.[4] This leads to the suggestion that judges may

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[1] Andrew D. Head, "The Charter in the Supreme Court of Canada: The Importance of Which Judges Hear an Appeal" (1991) 24:2 Canadian J. of Political Science 289-307; Sidney R. Peck, "An Analytical Framework for an Application of the Canadian Charter of Rights and Freedoms" (1987) 25 Osgoode Hall L.J. 1; Dennis Lloyd, *The Idea of Law* (London: Penguin Books, 1977), pp.212-220; Glendon Schubert, "Political Culture and Judicial Ideology" (1977) 9 Comparative Political Studies 363-408; J.A.G. Griffith, *The Politics of the Judiciary* (London: Fontana/Collins, 1979), pp.187-216; Roger Cotterrell, *The Sociology of Law* (London: Butterworths, 1984), pp.228-258.

[2] Peter McCormick and Ian Greene, *Judges and Judging* (Toronto: James Lorimer & Co., 1990), p.72.

[3] Heard, op.cit., p.290.

[4] Marc Gold, "The Mask of Objectivity: Politics and Rhetoric in the Supreme Court of Canada" (1985) 7 Supreme Court L.Rev. 455-510.

also disguise their personal values in the judicial decision making process.[1] An analysis of tax cases could provide some clues as to whether the judiciary has taken economic reality into account.

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[1] Ibid.

II. Methodology in Measuring Economic Reality

Two fundamental assumptions in economic theory are that man is a rational maximizer of his self-interest, and that human resources are scarce.[1] Accordingly, the behavioural pattern of a person would change in order to increase his self-interest in his environment, and efficiency is of paramount concern. According to economists, efficiency is the use of economic resources to produce the maximum level of satisfaction possible with the given inputs and technology. These propositions of incentives and efficiency are the fundamental concepts of economics.[2]

The use of economic analysis in law can be dated back to Adam Smith (1723 - 1790), who advocated the use of law to regulate the economic system.[3] This approach has evolved parallel to the development of economics as a discipline and the increase in governmental intervention in the economic system. One remarkable contribution of Smith is the

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[1] There are various definitions of economics. In general, it refers to "the study of how societies use scarce resources to produce valuable commodities and distribute them among different groups." See Paul A. Samuelson and William D. Nordhaus, *Economics* (New York: McGraw-Hill Book Company, 13th edn. 1989), pp.4-5; Self-interest here refers to self-satisfaction and should not be confused with selfishness. It includes the happiness or misery of other people. See Richard Posner, *Economic Analysis of Law* (Boston: Little, Brown and Company, 2nd edn., 1977), pp.3-4 and 23.

[2] Posner, *Economic Analysis of Law*, pp.4-10.

[3] Richard Posner, "Some Uses and Abuses of Economics in Law" (1979) 46:2 The University of Chicago L.Rev. 281.

development of the anti-trust law based on his remarks on conspiracies in the area of restraint of trade. Tax law can be traced to back to similar developments. Another use of economic analysis in law can be attributed to Jeremy Bentham (1748 - 1832), who analysed laws which regulate non-market behaviour, such as criminal and family laws.[1] According to Bentham, people are rational maximizers of their satisfaction, and, hence, a "price" can be attached to everything.[2]

The theories of economic analysis in law advanced by Karl Marx (1818 - 1883) have dominated the Communist world for almost half a century. He viewed law as the tool used by one class to dominate another class,[3] and predicted the demise of the free market economy.[4] He was unconcerned with individual justice and justified the price paid by bloody revolutions.[5] His mode of economic analysis in law has proven to be a failure in the light of the developments in the Communist world in the late 1980s and the collapse of

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[1] For some contemporary work, see Gary Becker, *The Economic Approach to Human Behavior* (Chicago: University of Chicago Press, 1976); ibid.
[2] e.g. setting a price for crime: "the severity of the punishment and the probability that it will be inflicted." Posner, "Some Uses and Abuses of Economics in Law" p.282.
[3] Karl Marx and Friedrich Engels, *The Communist Manifesto* (translated by S. Moore, 1964).
[4] Ibid.
[5] Ibid.

the Soviet Union in 1991.[1]

In contemporary times, Richard Posner and others advocate that judicial decisions should be concerned with the efficient use of economic and social resources in order to meet the demands of the people.[2] He suggests that judges should consider that loss is the product of wasteful, uneconomical resource use.[3] If the same can be said about the Canadian judicial decision making process, this would have important implications for tax cases. After all, as one scholar remarked, "[t]axation is a branch of political economy in which practical suggestions almost inevitably involve value judgements."[4] In preserving the independence of the judiciary, in that they should not transgress into the realm of ideology, it would be desirable for them to stay aloof from such controversy.

There are two distinct economic analyses of law. The first, known as normative analysis, attempts to explain what the law should be for the betterment of society.[5] The

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[1] However, Marxist scholars still argue that these so-called Communist countries had never practised Marx's theories.
[2] John Bell, *Policy Arguments in Judicial Decisions* (Oxford: Clarendon Press, 1983), p.75.
[3] Posner, *Economic Analysis in Law*, p.181.
[4] Cedric Sanford, *Taxing Personal Wealth: An Analysis of Capital Taxation in the United Kingdom* (London: George Allen and Unwin, 1971), p.23.
[5] For some pioneering works, see Guido Calabresi, *The Cost of Accidents: A Legal and Economic Analysis* (New Haven: Yale University Press, 1970); Posner, "Some Uses and Abuses of

second, known as positive analysis, attempts to explain what the law is, has been, or will be, to explain what the world is.[1] Economic analysis has been defined as the science of rational human behaviour and efficiency is maximized by rational human behaviour.[2] Therefore, law can be best understood and explained in terms of promoting the efficient allocation of resources.[3] The concept of efficiency is the maximizing of human resources and the minimizing of cost.[4] We shall try to take the second approach to investigate whether Canadian tax cases support the assumption that judicial interpretations tend to promote economic efficiency.

A. The Application of Economic Theory in Tax Scholarship

The effects of tax policy on the economy are topics of great interest to economists. Tax policy here refers to income tax statutes, their application and their interpretation by the judiciary. Economists have developed basic price theories regarding the effect of tax policy on the supply of labour, the supply of savings, risk-taking, investment decisions, corporate financial policy, and the

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[5](cont'd) Economics in Law" p.285.
[1] Posner, "Some Uses and Abuses of Economics in Law" p.287.
[2] Posner, "Some Uses and Abuses of Economics in Law" p.285.
[3] Posner, *Economic Analysis of Law*, pp.16-17.
[4] Ibid at p.10-12.

distribution of income.[1] While legal scholars are concerned with value judgements and distributional choices are made explicit in tax policy analysis, economists are more concerned with the efficient cost of tax.[2] Legal scholars would have to rely on the findings of the economists to test the validity of their theories, for example, the ultimate effect of tax policy on resource allocation and income and wealth distribution.

The advancement of legal scholarship in the field of taxation is closely related to the development of economists' techniques. The use of complex general-equilibrium economic models can estimate the effect of wealth distribution. Such models would cover every possible behaviour response to alternative tax rule.[3] This type of analysis has been used to a certain extent by scholars in Canada. The extent to which the Canadian courts accept this economic analysis and evidence will be investigated.

In the application of economic analysis to law, Ronald Coase is one of the pioneers with his article, "The Problem

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[1] Neil Brooks, "Future Directions in Canadian Tax Law Scholarship" (1985) 23:3 Osgoode Hall L.J. 441 at 461.
[2] Brooks, op.cit., pp.462-463.
[3] It has been predicted that legal scholarship in taxation will enter a new era as these economic models are further developed. See Brooks, op.cit., p.464.

of Social Cost."[1] His idea is known as the *Coase Theorem* which in 1991 made him the first legal scholar to receive a Nobel Prize. Coase is a firm believer in governmental non-intervention; that private disputes are best left to the parties to sort out their differences in economic terms. According to Coase, if there is no transaction cost, (for example, legal cost), then an efficient outcome will occur regardless of the legal rules, that is, no matter who is being assigned the legal right. If there is a transaction cost, then the efficient outcome may not occur under every legal rule. The preferred legal rules would be those which would minimize the transaction cost.

B. The Application of Economic Analysis in The Judicial Process

From time to time, common law judges do justify their opinions beyond the doctrine of *stare decisis* by resorting to moral, political, institutional and other social considerations.[2] Judges often must resort to these exterior

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[1] Coase, "The Problem of Social Cost", (1960) 3 J. Law & Econ. 1-44.

[2] Robert S. Summers, "Two Types of Substantive Reasons: The Core of a Theory of Common Law Justification" (1978) 63 Cornell L.Rev. 707; At common law, there is a doctrine of public policy that operates to take account of social interests. See Roscoe Pound, "A Survey of Social Interests" (1943) 57 Har. L.Rev. 4-8; Cheshire, Fifoot, and Fumston's *Law of Contract*, 11th ed., ed. M.P. Furmston (London:

sources in cases where no relevant precedents are available, when making a first impression decision, where two relevant precedents do not reconcile, where the change in circumstances necessitates the reconsideration of old authorities, and where the scope of a precedent has to be defined. After all, legal theories are merely a set of dogmas which judges and lawyers apply to justify the outcome of a case according to their wishes.[1]

In *R. v. Askov*,[2] the Supreme Court of Canada expressly took economic reasons into account in determining the existence of systemic or institutional delay. Legal scholars have argued that these exterior sources prevail over appeals to authority in the common law.[3] The introduction of economic analysis in the judicial decision making process has been advocated by an increasing number of academics over the past 25 years.[4]

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[2](cont'd) Butterworths, 1986), pp.376-409; A judicial decision might well be legally sound, but it could also be condemned as harsh by the public if it does not conform with economic reality.

[1] Mark Tushnet, "Following the Rules Laid Down: A Critique of Interpretation and Neutral Principles" (1983) 96 Harv. L.Rev. 781 at 821-822.

[2] [1990] C.C.C. (4d) 449 at pp.485-492 (S.C.C.).

[3] Summers, op.cit., pp.730-734.

[4] e.g. Posner, *Economic Analysis of Law*; "Utilitarianism, Economics, and Legal Theory" (1978) 8 J Legal Stud 103; Jeremy M. Miller, "Economic Analysis of Legal Method and the Law: The Danger in Valueless Values" (1985-86) 21 Gonz. L.Rev. 425-55; George Cohen, "Posnerian Jurisprudence and Economic Analysis of Law: The View from the Bench" (1985) 133 University of Pennsylvania L.Rev. 1117-1166.

According to two American jurists, few judges have taken an economic analysis approach in reaching their decisions other than those which deal with monopoly regulation and the like.[1] However, some have observed that economic logic has been guiding the judicial decision making process.[2] It has been observed that there is a recent trend towards using economic analysis in the United States federal courts.[3] A review of Canadian scholarly literatures sheds very little light regarding the existence of these exterior reasons in the judicial decision making process. The decision of the British House of Lords in *British Railways Board v. Herrington*[4] shows that the resources of the defendant are an important factor in determining tortious liability although the economic cost to the community was not considered. The court would require a higher standard of care from a large corporation. The British law lords made their decision in line with modern social conditions and humanitarian principles.

In measuring the extent to which economic reality affects the judicial decision making process, pure doctrinal

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[1] Robert S. Summers and Leigh B. Kelly, "'Economists' Reasons' for Common Law Decisions - A Preliminary Inquiry" (1981) 1 Oxford J. 213 at 214.
[2] Posner, *Economic Analysis of Law*, pp.25-249.
[3] Laurence H. Tribe, "Court Weighs Principles and Finds Them Wanting" 22 July 1984, Los Angeles Times.
[4] [1972] A.C. 877; (1972) 88 L.Q.R. 310 (H.L.).

work in legal scholarship is insufficient. Recent research has asserted that the knowledge a judge has plays an important role in any decision making process, and that creative ideas are exposed to social pressures.[1] In the sphere of the judicial decision making process, it has been argued that the education and experience of a judge would produce a "mind-set" with regard to the outcome of a case.[2] Therefore, methodologies from other disciplines would have been borrowed.

Judicial decision making and public policy making are inevitably interwoven.[3] In adjudicating cases, judges have to operate within the legal framework. They have to follow the statutes and common law rules in interpreting tax cases in order to achieve the public policy goal. On the other hand, legislators are subject only to constitutional restraint and the political and economic structure in formulating their public objectives. However, both the judges and legislators in reaching their decision on public policy matters would be influenced by their values.[4]

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[1] Robin Hogarth, *Judgement and Choice* (Toronto: John Wiley & Sons, 2nd edn. 1987), pp.132-150; Posner, "Some Uses and Abuses of Economics in Law" pp.153-175.
[2] Donald Armstrong, "My Lady of the Law is No Economist; My Lady Competition Law is No Lady" in Frank Mathewson, Michael Trebilcock and Michael Walker ed., *The Law and Economics of Competition Policy* (Vancouver: Fraser Institute,1988), pp.392-398.
[3] Bell, op.cit., pp.1-39.
[4] For a discussion, see supra, p.27.

We all know that tax law is a statutory field and judicial interpretation is inevitable. Common law plays a major role in judicial interpretation. In interpreting statutes, the judiciary often goes beyond querying the meaning of the relevant provisions, and assumes the role of judicial creativity.[1] According to an analysis by one leading jurist, the judiciary fills in the gap where the legislature fails to foresee.[2] In applying economic analysis in adjudicating tax cases, there is ample space for the judiciary to be creative within the legal framework.

Some legal scholars tend to believe that anything beyond reading statutes, comparing cases, and critical reasoning would be outside their ambit.[3] Such a view seems narrow-minded. In the analysis of a particular problem in tax law, such a tendency does not enable tax scholarship to investigate the need of the society. Tax scholarship should be able to consider the problems relating to economic and social circumstances,[4] to bring in ideas from other disciplines and deal with problems as economists and psychologists would.

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[1] H. Jones, "Statutory Doubts and Legislative Intention" (1940) 40 Colum. L.Rev. 957 at 970; Reed Dickerson, *The Interpretation and Application of Statutes* (Boston: Little Brown and Co., 1975), p.23.
[2] Jones, op.cit., pp.971-972.
[3] Brooks, op.cit., p.444.
[4] Brooks, op.cit., p.474.

C. Methodological Issues in Economic Reasoning

Robert S. Summers and Leigh B. Kelly have developed a model for economic analysis in common law decisions.[1] The exterior reasons as discussed above are called 'substantive reasons'. According to them, goal reasons and rightness reasons are the two basic types of substantive reasons to be found in common law cases. Goal reasons support a decision which serves a good social goal.[2] Rightness reasons support a decision which accords with a socio-moral norm of rightness as applied to a party's past actions or to a state of affairs resulting from those actions.[3] In terms of economic analysis, goal reasons can be sub-classified into *Pareto-superior* reasons and *Kaldor-superior* reasons as they serve social objectives.[4]

Pareto-superior Reasons

One of the objectives of Canadian tax policy is the reallocation of resources and redistribution of wealth in order to achieve social goals. In measuring whether a particular tax policy has achieved horizontal and vertical equity in an efficient manner, economists have devised measurement techniques. One of these is attributed to

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[1] Summers and Kelly, op.cit., pp.213-255.
[2] Summers and Kelly, op.cit., p.213.
[3] Summers and Kelly, op.cit., p.214.
[4] Summers and Kelly, op.cit., p.215.

Vilfredo Pareto (1848 1923).[1] According to Pareto, a reallocation of resources is *Pareto-superiority* to an antecedent allocation if it makes "no person worse off and at least one person better off."[2] This is in answer to Bentham's utilitarianism of measuring happiness across the people in determining the effect of the policy on total utility.[3] Courts do decide cases in terms of maintaining family harmony, enhancing public convenience, and promoting better labour-management relations.

The reallocation of resources can be performed in many ways. This can be done by private parties bargaining in a free market: there will be give and take in the allocation of resources. Reallocation can also be achieved by a single individual who makes a decision for both parties, for example, in an adjudication process. In the sphere of tax law, settlements are sometimes made by taxpayers, who have

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[1] Summers and Kelly, op.cit., p.215.

[2] A situation is said to be *Pareto-efficient* if there is no change from that situation which can make no person worse off and at least one person better off. Conversely, a situation is not *Pareto-efficient* if there can be change from that situation which makes no person worse off and at least one person better off. See Paul A. Samuelson and William D. Nordhaus, *Economics* (New York: McGraw-Hill Book Company, 13th edn. 1989), pp.747-749; Jules L. Coleman, "Efficiency, Exchange, and Auction: Philosophic Aspects of the Economic Approach to Law" (1980) 66 Cal. L.Rev. 221; Richard Posner, "The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication" (1980) 8 Hofstra L.Rev. 487 at 488; ibid.

[3] Ponser, ibid; Note that utilitarianism is criticized for allowing individual injustice by its preoccupation with the greatest good of the greatest number.

limited bargaining power with Revenue Canada, rather than resorting to common law. In reaching a *Pareto-superior* decision, a common law judge would apply the economic analysis.

A *Pareto-superior* reason is relevant only to justify a change or to justify not making a change.[1] In making a change, at least one person would be better off and no one would be worse off. In not making a change, no one would gain or someone would lose. When *Pareto-superior* reason is taken into account, the common law judge must act *intra vires*, that is, he must have the power to allocate resources.

There are four types of common law situations relevant to the application of *Pareto-superior* reasoning. In a situation where the judge is merely applying common law precedents and not deciding whether to depart from the *status quo*, a *Pareto-superior* reason is irrelevant.[2]

A second type of case is where the common law court is faced with the choice of whether to make new law by overruling or modifying an existing right of a party.[3] Under such circumstances, *Pareto-superior* reason is used by the court to decide whether someone would be better off and no

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[1] Summers and Kelly, op.cit., p.222.
[2] Summers and Kelly, op.cit., p.222.
[3] Summers and Kelly, op.cit., p.222.

one would be worse off, or otherwise. In the sphere of employment relationship, the Federal Court of Appeal has reversed a Tax Court's decision and indicated a reluctance to follow the single criterion test. In *Wiebe Door Services Ltd. v. M.N.R.*,[1] the court looked at the whole scheme of operations to determine the master and servant relationship. Obviously, the successful applicant was better off. Although the Minister of Revenue could not collect the Unemployment Insurance Premiums and Canada Pension Plan contributions, it simply had no legal obligation to provide these services to those affected, and those affected had an understanding that they would be regarded as independent contractors who would in turn be responsible to Revenue Canada. Therefore, no one, including the loser, would be worse off.

A third type of situation is cases of first impression.[2] The court is bound to create new law although it is often a matter of degree as to how close the case of first impression overlaps with existing cases. From the outset, the rights of both parties are uncertain. The common law court would have to assign the right to each party so that both parties would be better off than at the starting point, that is, at least one party would be better off and

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[1] [1986] 2 C.T.C. 200, 87 D.T.C. 5025 (F.C.A.).
[2] Summers and Kelly, op.cit., p.223.

no one would be worse off. In this case, *Pareto-superior* reason can support a decision. A taxpayer who loses his case under Section 245 of the *Income Tax Act* and is denied tax benefit arising from an avoidance transaction would not be worse off unless a penalty is imposed: he has to pay tax had there been no such avoidance arrangement. However, Revenue Canada would be better off: it did not know whether the court would consider the particular arrangement to be *bona fide*, and, hence, it has no existing right.

The last type of situation is in cases where the precedents do not reconcile.[1] From the outset, the rights of both parties are uncertain. The situation would be the same as above. Alternatively, there can be losers if one of the parties is assumed to hold the right in question to any degree.

The court can always inquire about the kind of settlement the parties would agree to should the actual dispute arise. From the inquiry, the court can then apply *Pareto-superior* analysis to the last three types of situations. This would be speculative. In most common law cases, the above *Pareto-superior* situations rarely arise.[2]

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[1] Summers and Kelly, op.cit., p.223.
[2] For a detailed discussion see Posner, "The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication" pp.502-507.

Kaldor-superior Reasons

In a *Kaldor-superior* situation, there is a loser as well as a gainer, but the gainer's gains are such that he could compensate the loser's losses and still have some gain left.[1] No actual compensation need be paid. Insofar as the gainer gains more than the loser loses, a *Kaldor-superior* reallocation is considered as efficient in achieving the goal of overall welfare improvement. However, economists find it difficult to compare gains and losses of different persons as this would be subjective.

In *Day and Ross Ltd. v. Her Majesty the Queen*,[2] the taxpayer was allowed deductibility of fines as business expenses under paragraph 18(1)(a) of the *Income Tax Act*. Although the taxpayer was the loser by paying the fines, the court considered these as reasonable expenses made for the purpose of gaining or producing income, that is, for the efficient running of the business.[3] Therefore, its losses were compensated by the income it made. The court did not

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[1] Coleman, pp.239-242; Posner, "The Ethical and Political Basis of the Efficieny Norm in Common Law Adjudication" pp.490-492; Summers and Kelly, op.cit., p.224.
[2] [1976] C.T.C. 707, 76 D.T.C. 6433 (F.C.T.D.).
[3] Section 67 of the *Income Tax Act* provides that the expenses must be reasonable in the circumstances. In *Moldowan v. Her Majesty the Queen*, [1977] C.T.C. 310, 77 D.T.C. 5213 (S.C.C.), Dickson J. established an objective test as to whether or not any business had a reasonable expectation of profits. This objective determination had to be made from all the facts. See also *M.N.R. v. Eldridge*, [1964] C.T.C. 545, 64 D.T.C. 5338 (Ex.).

consider the deduction as an "outrageous transgression of public policy."

In most common law cases, one side would win and the other side would lose. However, a *Pareto-superior* reallocation contemplates no losers. The *Kaldor-superior* criterion would then be available while the *Pareto-superior* criterion would not.

The Limits of Economic Reasoning in Law

In order to adjudicate a case by applying economic analysis, a judge has to accept some economic basis in deciding what is a cost and what is a benefit and in assigning societal values to various costs and benefits.[1] The judge must weigh competing values with a common denominator and often has to convert them in pecuniary terms. Short of having a common denominator, the analysis would not be economic analysis according to this definition.

There are two issues relating to economic analysis in law. One is the extent to which the judiciary should apply economic analysis. A line has to be drawn in applying economic reasoning between what is traditionally the jurisdiction of the courts and what is traditionally the jurisdiction of the legislators. Constitutional questions

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[1] Robert Bork, "The Role of the Courts in Applying Economics" (1985) 54 Antitrust L.J. 21 at 22.

will undoubtedly arise as well as the training and background of the judges in applying economic theories in the judicial decision making process in addition to scientific evidence, for example, statistical data used to verify the economic theory. Can the courts apply economic analysis better than the legislators?[1] There are two schools of thought in applying economics to law.[2] The Chicago school advocates that only those arguments that are acceptable to economists are the appropriate forms of legal arguments.[3] The Yale school believes in the application of economic analysis as a pervasive role in the making of better judicial decisions.[4] We shall discuss these practical problems in the following sections.

The second issue is what kind of analysis can be called economic analysis. The goals of economic analysis could be the redistribution of wealth and power or the enhancement of efficiency. We have already discussed this previously.

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[1] Note (#1), "The Inefficient Common Law" (1983) 92 Yale L.J. 862 at 885-887.
[2] Bruce A. Ackerman, "Law, Economics, and the Problem of Legal Culture" (1986) Duke L.J. 929.
[3] Ibid.
[4] Ibid at p.930.

D. The Problems of Economic Analysis in the Judicial Process

The application of economic analysis in the judicial decision making process has been a topic of academic debate. Some proponents tend to suggest that economic analysis can resolve all the problems in common law jurisprudence.[1] Some take a different view.[2]

Some American jurists argue against such an approach by reason that constitutional issues are circumvented,[3] that is, an economic approach in judicial decision making presupposes a schedule of prices in which options can be weighted on society's scale rather than a particular aspect of a case.[4] Although the application of economic analysis in law might provide some rationality, caution has to be taken to avoid frustrating genuine judicial understanding of the merit of each case.[5] The judiciary has to make hard constitutional choices in reaffirming and creating, selecting and shaping, "the values and truths we hold sacred".[6] It is the duty of the judges "to hold up before us

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[1] Frank Easterbrook, "Method, Result, and Authority: A Reply" (1985) 98 Harv. L.Rev. 622-629.
[2] Posner, *Economic Analysis of Law*, pp.19-23.
[3] Laurence H. Tribe, "Constitutinal Calculus: Equal Justice or Economic Efficency?" (1985) 98 Har. L.Rev. 592-621; For an article on the exchange between Easterbrook and Tribe, see Eleanor Fox, "The Politics of Law and Economics in Judicial Decision Making: Antitrust as a Window" (1986) 61 The Politics of Law and Economics 554-588.
[4] Tribe, op.cit., p.606.
[5] Patricia Wald, "Judicial Review of Economic Analyses" (1983) 1 Yale J.on Reg. 43 at 62.
[6] Ibid at pp.595.

the sort of society we desire, so that we may be helped, not simply to live by our ideals, but to gain in our understanding of what our ideals are and what they may require of us."[1]

In the sphere of taxation legislation, the judiciary has a duty to interpret it and to apply the doctrine of precedent. It has the duty to ascertain the intention of Parliament. The judiciary is not prohibited from taking economic reality into consideration in accordance with the social circumstances.[2] It has been argued that the role of the judiciary is to support the free market economy because maximizing free choice by individuals would maximize social wealth.[3] Thus the government's efforts to advance equality, to redistribute wealth and power, and to protect particular groups from exploitation would be limited.[4] Some proponents of economic analysis of law take the view that resources can be utilized efficiently in a free market economy.[5]

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[1] Edward Spaeth, "Where is the High Court Heading?" (1985) Summer Judges at 48.
[2] The "reasonable limit" clause in Section 1 of the *Canadian Charter of Rights and Freedoms* and the "remedial" and "fair, large and liberal construction and interpretation" clauses of Section 12 of the *Interpretation Act*, R.S., c.I-23, s.11., provide the judiciary with very wide authority to interpret the tax statute.
[3] Patricia Wald, "Limits on the Use of Economic Analysis in Judicial Decisionmaking" (1987) 50:4 Law and Contemporary Problems 225 at 226.
[4] Ibid at 226.
[5] Ponser, *Economic Analysis in Law*, p.9.

On the practical side, people who come to court are more interested in winning a case than in setting a precedent. For the advocates of using economic analysis in the judicial decision making process, courts are a societal mechanism for resource allocation. If this approach is taken, then it is possible that the future effects of the judicial rulings prevail over the immediate interest of the vying parties.[1] This is a departure from the traditional view that each case should be determined according to its own merit and runs the risk that the court would decide important issues without considering all the circumstances.[2] In any event, a court decision can have a precedent-setting effect and will affect future events. Moreover, the constitution is based on the assumption that the interests of society can be best served by protecting the rights and freedoms of the individual,[3] and, hence, it may be viewed as anti-majoritarian and anti-democratic.

Most economic analyses focus on efficiency and avoid the issue of fairness in resource allocation. Economists are not interested in who should bear the cost of the case at

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[1] Frank Easterbrook, "The Supreme Court, 1983 Term - Foreword: The Court and the Economic System" (1984) 98 Harv. L.Rev. 4 at 10-12.

[2] Ian Shapiro, "Mr. Justice Rehnquist: A Preliminary View" (1976) 90 Harv. L.Rev. 293.

[3] Alex Kozinski, "Foreword" in James Dorn and Henry Manne ed., *Economic Liberties and the Judiciary* (Fairfax: George Mason University Press, 1987), p.xv.

bar, but they are more concerned with methods of preventing future occurrence and reducing costs.[1] The parties in the case at bar are concerned with the merit of the case itself and have no interest in the future.[2] However, advocates of law and economics suggest that the spirit of common law is simply the pursuit of efficiency. According to Paul Rubin, resorting to court would be less likely where the legal rules are efficient.[3] According to Richard Posner, "common law exhibits a deep unity that is economic in character."[4] In a routine court case, the allocation of the resource is often the subject matter.[5] There will be a winner and a loser. If the court adopts such an economic view, who is here to deliver individual justice?

Chief Judge Wald, of the United States Court of Appeals, questioned the ability of the judiciary to analyse economic techniques and to ascertain assumptions.[6] According to her, the analysis is complicated by "controversial, powerful, and purposefully comprehensive assumptions about human beings, society and courts." Moreover, the backgrounds

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[1] Posner, *Economic Analysis of Law*, p.18.
[2] Posner, *Economic Analysis of Law*, p.18.
[3] Paul Rubin, "Why is the Common Law Efficient?" (1977) 6 J. Legal Stud. 51.
[4] Posner, *Economic Analysis of Law*, p.179-191.
[5] Jack Hirshleifer, "Evolutionary Models in Economics and Law: Cooperation Versus Conflict Strategies" (1982) 4 Res. L. & Econ. 1 at 5, 46.
[6] Wald, "Limits on the Use of Economic Analysis in Judicial Decisionmaking" p.227.

of the judges would prevent the advancement of this new ideology which encompasses economic, social, and political relationships.[1]

In the American school of jurisprudence, a mechanism based on economic analysis as to how the legislative process operates has been formulated to interpret statutes.[2] In the legislative process, the influence of pressure groups is inevitable. Therefore, law might serve the interests of the vocal groups more than the public at large. According to the advocates of this approach, private interest laws are merely "deals" between the legislators and the pressure groups. Such private laws should be interpreted narrowly while the laws which serve public interest should be construed broadly to advance their purpose.[3] This again departs from the traditional role of the judiciary who should not inquire into the operation of the legislative process but only give effect to the intent and purpose of the legislation.[4]

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[1] Ibid at 228-230.
[2] Note (#1), op.cit., pp.885-887; Wald, op.cit., pp.240-241.
[3] Posner, *Economic Analysis of Law*, pp.261-72; Easterbrook, op.cit., pp.14-18.
[4] Jabex G. Sutherland, #48.17, S. Dallas Sands ed., *Statutory Construction* (Chicago: Callaghan, 4th ed. 1984), p.340.

E. Methodology

This thesis is intended to analyse whether economic reality has been taken into consideration by the courts in tax cases rather than to support the hypothesis that economic reality has been accepted into the Canadian tax jurisprudence. The acceptance of economic reality can be found in the *ratio decidendi* or merely *obiter* of a case. As a starting point, the tax cases at the federal court will be analysed to test the historical trend of the judiciary and whether there is a judicial pattern of economic reality. We are more interested in recent trends. Accordingly, all federal court cases since 1986 will be studied more closely.

We shall then analyse all the Supreme Court of Canada tax cases since 1983, when the *Canadian Charter of Rights and Freedoms* came into operation, to investigate whether economic reality has affected its judicial decision making process and has met the approval of the highest court in a modern industrialized society. After the analysis, we shall discuss the merits of both sides of the coin in applying economic reality.

Since 1975, cases appealed to the Supreme Court by rights have been reduced dramatically by the *Supreme Court Act*. The cases which make their way to the Supreme Court are usually of major public importance and involve the decisions

of two levels of inferior courts.[1] On a more practical level, the judicial decision making process of the Supreme Court cannot be fettered. The following analytic approach will be used:[2]

I. Application: What is the law applicable to each case at bar, that is, Has the judge applied economic analysis to the facts of the case? It has been stated that the common law method is the allocation of responsibilities between parties in order to maximize the joint value, that is, to minimize the joint cost of the activities.[3] In traditional legal analysis, the relevant legal theory would be summarized before applying to the facts in rendering a judicial decision. However, as one leading jurist suggested, "true grounds of legal decision are often concealed rather than illuminated by the characteristic rhetoric of judicial opinions."[4]

Whether economic analysis has been used may be detected. The use can be both patent and latent and can be both intentional and unintentional. The court may use economic analysis to justify its decision, or the case itself is decided on economic efficiency. In analyzing English law of

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[1] Subsection 31(1), *Supreme Court Act*, R.S.C. 1985, c. S-19.
[2] For a detailed discussion, see Cohen, op.cit., pp.1165-1166.
[3] Posner, *Economic Analysis in Law*, p.179.
[4] Ponser, *Economic Analysis in Law*, p.18.

nuisance, Ronald Coase concluded that it has an "implicit economic logic."[1] Richard Posner has reached a similar conclusion in his study of a late nineteenth century negligence case.[2]

II. Justification: Have the judges justified the use of economic analysis in their decision? This raises several issues in policy questions.[3] The first one is the goal desirability: whether the economic goal should be pursued at all.[4] If the answer is to the affirmative, then the means to pursue the goal should be settled. Would it be economic analysis? The last question would be whether economic analysis is the most effective means.

III. Limitation: What is the limit of the application of economic analysis in the case? In interpreting tax cases, the judiciary may take a logical approach and the application of economic analysis is incidental to it.[5] However, there can be an occasion where a case is decided outside the limit of legal reasoning. The court may take a *de facto* approach to circumvent the undesirable economic consequences of a *de jure* approach. Tax law itself is

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[1] Coase, "The Problem of Social Cost", pp.1-44.
[2] Posner, *Economic Analysis in Law*, pp.185-188.
[3] Neil MacCormick, *Legal Reasoning and Legal Theory* (Oxford: Oxford University Press, 1978), pp.262-263.
[4] Ibid.
[5] In *Keizer v. Hanna and Buch* ([1978] S.C.R. 342), the only logical approach the Supreme Court had to follow was to accept the economic data.

statutory and, hence, the rules are artificial and limited to the scope of the tax framework. In theory, the judiciary cannot go beyond the intention of Parliament. In practice, the intentions of Parliament can be interpreted differently by different judges.

III. Economic Reality in Federal Court Cases

A. Introduction

Before we analyse the Supreme Court tax cases, we shall discuss a few cases where the federal courts have taken an economic approach in their judicial decision making process. As we are concerned only with economic reality, the cases selected are those where the courts specifically referred to and applied the economic reality test. We have discussed the various theories relevant to the economic analysis of law in the preceding chapter. In some instances, the application of an economic approach is an inevitability rather than an advancement of the social goal of the court, for example in determining whether there is a reasonable expectation of profits in setting up a business. Valuation of property is a typical case,[1] and these cases do not involve the reallocation of resources.

In *Moloney v. Her Majesty the Queen*,[2] Judge Joyal of the Federal Court Trial Division re-emphasized the common sense approach in the interpretation of the *Income Tax Act*. In that case, the taxpayers subscribed to a complex scheme,

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[1] See *Elworthy v. Her Majesty the Queen*, [1982] C.T.C. 62, 82 D.T.C. 6067 (F.C.T.D.); and in *M.N.R. v. Members of Northwood Country Club*, [1989] 89 D.T.C. 173 (T.C.), the Tax Court of Canada had to decide which economic approach is more appropriate.

[2] [1989] 89 D.T.C. 5099 (F.C.T.D.).

the results of which enable them to claim the amount each of them invested in a business venture as a business expense. Each taxpayer would invest $20,000 but receive $17,500 cash bond as a form of peformance guarantee. The question is whether each taxpayer was entitled to claim the $20,000 as tax deduction. The court found that there was no business purpose with a view to make a profit and the whole scheme was for tax benefits. Ostensibly, these investments did not enhance the efficiency of the business: no aspect of the business operation would be better off although no aspect would be worse off as a result.

After praising a paragraph from *Her Majesty the Queen v. Phyllis Barbara Bronfman Trust*,[1] which confirms the prevalence of economic reality over juristic formalism, Judge Joyal said:

> "They underline an objective and common sense approach to statute interpretation and bring added respect for the commercial and economic realities of transactions which have tax connotations. It is an approach which also undermines any attempt to reduce the tenor of the statue to the absurd."

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[1] See supra, p.26.

The application of economic analysis in tax cases is not novel in Canadian federal courts although academic writers often omit this important aspect in their analyses.[1] In *Symes v. Her Majesty the Queen*,[2] Judge Cullen of the Federal Court Trial Division took economic realities into account in allowing the deduction of the nanny's salary from the income tax of the taxpayer. He took the view that it would be in line with the significant social changes in the late 1970s and into the 1980s in terms of the influx of women of child-bearing age into business and the work force. He rejected the *stare decisis* of the cases decided in the 1950s and the 1960s as they were based on the reasoning of a decision made in 1891. However, at the Federal Court of Appeal,[3] the appeal by the Crown was allowed:

> "The Court is here being asked not only to fish in the most troubled socio-economic waters, but also to swim against the tide of a solution expressly adopted by Parliament in preference to that proposed by the respondent."

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[1] See for example, Faye Woodman, "A Child Care Expenses Deduction, Tax Reform and the *Charter*: Some Modest Proposals" (1990) 8 Can. J. of Family Law 371-387.
[2] [1989] 89 D.T.C. 5243 (F.C.T.D.).
[3] [1991] 91 D.T.C. 5397 (F.C.A.).

The *Symes* case indicates that judicial opinions in accepting economic reality do not reconcile. The Federal Court of Appeal clearly took the view that a strict interpretation approach should be taken as accepting the economic reality would be too complicated for the courts to handle. This confirms a concern that the training and background of the judges could be a factor in setting the limit of accepting economic reality.[1] If economics were an exact science, the judiciary would be more ready to accept it. Lie-detector tests have been rejected as evidence because their reliability is based on psychological theories which are not exact science.[2] However, breathalyzer tests have been accepted as evidence because their reliability is based on medical theories which are exact science.[3] In each of the following sections, we shall investigate the acceptance of economic reality in particular types of tax topics. Although this investigation is exploratory and speculative, it is a starting point.

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[1] *Supra*, p.46.
[2] *R. v. Beland*, [1987] 2 S.C.R. 398 (S.C.C.).
[3] *R. v. Crosthwait*, [1980] 1 S.C.R. 1089 (S.C.C.).

B. Employer and Employee Relationship Cases

First, we shall discuss cases involving the test of contract of service and contract for services in tax law. In determining the nature of the relationship of the parties for the purpose of the *Income Tax Act*, the courts look at the substance rather than the form of the contract or the intentions of the parties. The substance the courts would often investigate is the economic reality.

In *Marotta v. Her Majesty the Queen*,[1] the taxpayer, a medical doctor, argued that the income he had received from the University of Toronto was an income from business as he was a partner with other doctors at the teaching hospital. The Federal Court Trial Division expressly used the "economic reality" test as one of the tests in determining whether a contract is a contract of service or a contract for services. The question asked here was whether the person was carrying on business for himself or for a superior, that is, who ran the risk of profit or loss? In other words, the "economic reality" test here is who utilizes the efficiency.

In *City of Montreal v. Montreal Locomotive Works Ltd. et al.*,[2] Lord Wright said:

> "In earlier cases a single test, such as the

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[1] [1986] 1 C.T.C. 393, 86 D.T.C. 6192 (F.C.T.D.).
[2] [1947] 1 D.L.R. 161 at 169-170; [1946] 3 W.W.R. 748 at 756-58.

> presence or absence of control was often relied on to determine whether the case was one of master and servant, mostly in order to decide issues of tortious liability on the part of the master or superior. In the more complex conditions of modern industry, more complicated tests have often to be applied. It has been suggested that a fourfold test would in some cases be more appropriate, a complex involving (1) control; (2) ownership of the tools; (3) chance of profit; (4) risk of loss."

One aspect of Lord Wright's tests comes down to an economic analysis, that is the question of economic risk. An independent contractor would undertake an economic risk, while an employee would not. If an employee does not supply any funds, assume any economic risks, or undertake any liability, it is obvious that he is under a contract of service. The employer would usually not suffer any additional economic loss by entering into a contract for services rather than a contract with an employee as they intended.

In contemporary society, the traditional control tests cannot be the decisive ones for a professional person. In

Boardman v. Her Majesty the Queen,[1] Judge Collier expressed such a concern. The court has to decide whether a contract between the Alberta Hospital and the psychiatrist is a contract of service or a contract for service. The contract was entered because the hospital wanted to attract well qualified psychiatrists. For efficiency, each well qualified psychiatrist could negotiate his own salary. Although the contract provided no pension rights and other fringe benefits given to doctors who were employees, the plaintiff was not required to accomplish a specified amount of work but was required to put his personal services at the disposal of the hospital. After analyzing the contract and considering *Alexander v. M.N.R.*,[2] Judge Collier concluded that the contract is "as a matter of business and economic reality, an employee" contract. The meaning of "economic reality" in this case in effect is the efficient operation of employer-employee contract.

C. Income from Business

The courts often have to consider whether the taxpayers were making any economic sense out of their acts. If the answer was to the affirmative, then the income was

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[1] [1979] C.T.C. 159, 79 D.T.C. 5110 (F.C.T.D.)
[2] [1970] Ex.C.R. 138 at 153-155; [1969] C.T.C. 715 at 724 (Ex.).

considered as business income. In determining whether an income is a business income from gaming, the court often has to draw a fine line and applying economic analysis is the only logical approach.

In *Graham v. Green (Inspector of Taxes)*,[1] the Tax Court took the view that the income which a person made from large and sustained scale betting on horses was not income from business as he could not "be said to organize his effort in the same way as a bookmaker organizes" his business. However, in *Walker v. M.N.R.*,[2] the court held that the income of a farmer who regularly bet on horses for a period of about 53 days each year was income from business because he could not be reasonably believed to "afford to lose much money on a hobby of this kind." The court ruled that the taxpayer's intention was to embark on business and to make profits out of it.

In *Molony v. M.N.R.*,[3] the taxpayer was dismissed from his employment with a chartered bank for having embezzled in excess of $10.2 million to finance his gambling losses. The taxpayer appealed to the Tax Court of Canada for deduction of such losses in computing of his income. The court

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[1] [1925] 2 K.B. 37, 94 L.J.K.B. 494, 133 L.T. 367, 9 T.C. 309.
[2] [1951] C.T.C. 334, [1952] 2 D.L.R. 46, 52 D.T.C. 1001 (Ex.).
[3] [1990] 90 D.T.C. 1394 (T.C.).

considered the taxpayer as a pathological gambler. It was therefore self-contradictory to speak of him as being in the business of gambling since gambling had impaired his intellect and sense of perspective. Although he genuinely expected to make a profit therefrom, such expectations were unreasonable.

The above cases indicate that the courts use an objective test rather than a subjective test. In other words, the question is whether the operation of the taxpayer is in reality economically sound. In a betting situation, resources are allocated between the bettor and the gaming operator. If probability is taken into account, the utilities would be in favour of the gaming operator. Otherwise, they could not be said to have made a profit. The courts would take into consideration the efficiency of the specific taxpayer's operation and would not inquire into whether it is against the odds. Otherwise, no person could bet and claim the income as profit.

D. Adventure or Concern in the Nature of Trade

In a number of cases where the courts have to decide whether a transaction is an adventure or concern in the nature of trade, the use of economic tools to analyse efficiency is inevitable. The merits in most of these cases

have been decided on whether the profit realized was a gain made in the course of business in carrying a scheme for profit-making. Evidence from the usual trade practice and the economic analysis procedures are considered by the courts in determining the nature of the transaction. The crucial question would be whether an investment or an adventure or concern in the nature of trade is more efficient. In considering the efficiency of the operation, the court would look at the speculative nature of the operation. A speculative operation would be a question of the efficiency in the allocation of the risk. It would more likely consider an operation to be an investment if the consideration of the taxpayer is one of confidence rather than of a speculative nature.

In *M.N.R. v. Taylor*,[1] the court looked at the "business nature" of the transaction in deciding whether the profit from an isolated transaction was the profit from an adventure or concern in the nature of trade. Thorson, P., analysed the profit and loss and the risk assumed by the taxpayer and concluded:

> "He was justified in his speculative venture. The Company got the benefit of a substantial draw back of approximately $30,000. The

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[1] [1956] C.T.C. 189, 56 D.T.C. 1125 (Ex.).

> respondent was rehabilitated with the Company in his own self esteem..... As for himself his venture brought him the personal satisfaction of victory as well as an increase in salary and pension rights."

In *Hughes v. Her Majesty the Queen*,[1] the court again analysed the profit and gain of the taxpayer's business and made a comparison between the potential profits of two intervals before it concluded that "there was a change of intent to one of selling for profit." The entire question is when the efficiency of the operation began to maximize with a view to selling for profit. It is clear that there is always a possibility of resale should there be a reasonable offer, but this does not itself prove the existence of a secondary intention to sell at a profit if the primary objective to invest fails.[2] The court would first look at whether the primary intention is a speculative one rather than an efficient investment operation.[3] An analysis of the cases[4] indicates that the crucial factor the court would

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[1] [1984] C.T.C. 101, 84 D.T.C. 6110 (F.C.T.D.).
[2] *Kit-Win Holdings (1973) Ltd. v. Her Majesty the Queen*, [1981] C.T.C. 43, 81 D.T.C. 5030 (F.T.C.D.).
[3] Compare *Regal Heights Ltd. v. M.N.R.*, [1960] 60 D.T.C. 1270 (S.C.C.) and *Riznek Construction Ltd. v. Her Majesty the Queen*, [1979] C.T.C. 197, 70 D.T.C. 5131 (F.C.T.D.). In the latter case, there was no speculation and everything ran in an efficient manner. The failure to obtain a permit was due to a calculated error.
[4] *Irrigation Industries Ltd. v. M.N.R.*, [1962] C.T.C. 215,

look at is whether the taxpayer has utilized the maximum efficiency as a trader or dealer rather than as an investor.

E. Conclusion

We have discussed a few categories of cases in which the only logical approach of the courts would be to apply economic analysis as they deal with business and fiscal matters. The analyses presented in federal court tax cases do not involve the use of complex mathematical models or economic theories, but rather they represent a common sense approach. Economic methods have been used both as an analytic tool and a resource allocation tool to achieve the goal of efficiency. The continuing use of economic analysis in the federal court tax cases indicates that there is a judicial trend towards accepting such an approach.

'(cont'd) 62 D.T.C. 1131 (S.C.C.); *Atlantic Sugar Refineries Ltd. v. M.N.R.*, [1948] C.T.C. 326, 4 D.T.C. 507 (Ex.); *Canadian Kodak Sales Ltd. v. M.N.R.*, [1954] C.T.C. 375, 54 D.T.C. 1194 (Ex.).

IV. Economic Reality in Supreme Court Tax Cases

A. Introduction

In Common Law jurisprudence, the introduction of economic analysis in law was not advocated by academics until the early 1960s.[1] The judicial movement in the Common Law world to adopt an economic approach was not developed until the 1970s.[2] Therefore, it is a modern day jurisprudence that we have to investigate. We shall analyse all the tax cases determined by the Supreme Court of Canada since 1983 when the *Canadian Charter of Rights and Freedoms* came into operation. Although most tax cases do not involve arguments on constitutional grounds, the *Charter* has brought the Canadian legal system within the framework of a contemporary democratic society. There is evidence of a recent judicial movement to take account of economic equality when considering the equality provision under Subsection 15(1) of the *Charter*.[3]

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[1] See supra, chapter II; Richard Posner, "The Law and Economics Movement" (1987) 77:2 Am. Econ. Rev. 1-13.
[2] It was only during President Ronald Reagan's term (1981-1988) that proponents of law and economics began to be appointed to the bench because of their views. The notable ones are Judges Robert Bork, Richard Posner, Frank Easterbrook, and Antonin Scalia.
[3] See *Symes v. Her Majesty the Queen*, [1989] C.T.C. 476 (F.C.T.D.) at 491-492.

B. Supreme Court Tax Cases in 1983

In 1983, the Supreme Court of Canada decided only two cases related to tax matters. The first case was *Nowegijick v. Her Majesty the Queen.*[1] Although this case was concerned with the *Income Tax Act* in the context of the *Indian Act*, a closer examination reveals that it has an economic component. Academic writers have omitted reference to this fact.[2] The second case, *Her Majesty the Queen v. Savage,*[3] was a case involving the determination of whether an amount received is taxable. This second case is a simply the application of an economic test, and the *ratio* of the first case was referred to by the court.

Nowegijick v. Her Majesty the Queen

The Fact

Mr. Nowegijick, an Indian within the meaning of the *Indian Act*, resided on the Gull Bay Reserve. He was an employee of the Gull Bay Development Corporation, a company having its head office and administrative offices on the reserve during the 1975 taxation year. He worked as a logger in an operation ten miles from the reserve. He lived on the

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[1] [1983] 1 S.C.R. 29-42.
[2] Donald Purich, "Indians and Income Tax" (1983) 48 Sask. L.Rev. 122-128; T.E. McDonnell, "Indians - Whether Salary Earned off the Reserve Taxable" (1983) 31:2 Can. Tax J. 228-230.
[3] [1983] 2 S.C.R. 428.

reserve and was paid bi-weekly at the head office on the reserve.

Revenue Canada assessed income tax against the salaries which Mr. Nowegijick received from the corporation. Mr. Nowegijick claimed that the assessment made is the "personal property of an Indian" situated on a reserve and thus not subject to taxation by virtue of Section 87 of the *Indian Act*. During the trial, the *Interpretation Bulletin* was relied on in favour of Mr. Nowegijick and the Crown said the Bulletin was simply wrong.

The Supreme Court in its unanimous decision held that: (1) administrative policy and interpretation are not determinative but are entitled to weight and can be an important factor in case of doubt about the meaning of the legislation; and (2) wages, whether taxed "in respect of", are property.

Analysis

The weight the court gave to the *Interpretation Bulletin* is not only precedent-setting' but also a result of inadvertent application of economic analysis. The court unknowingly follows the *Pareto-superior* reasoning in that no one would be worse off and at least one party would be

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' McDonnell, op.cit., p.230.

better off.[1] Revenue Canada could be not expected to suffer any loss in abiding by its own *Interpretation Bulletin*. From the outset it has full control in making its own directives. It must have taken into account all the relevant factors and it has all the bargaining power to do so. On a strict point of law, the *Interpretation Bulletin* has no legal effect. However, the Supreme Court reallocates the benefit of the doubt to the taxpayers. This would be a *Pareto-superior* allocation. This has made the taxpayers better off without making Revenue Canada worse off as it is assumed to be satisfied with its own *Interpretation Bulletin* although it argued against the *Interpretation Bulletin*. It can change the *Interpretation Bulletin* at any time if it needs to.[2]

If Revenue Canada was allowed to reject its own *Interpretation Bulletin* outright, an issue of efficiency would undoubtedly arise. By denying the *Interpretation Bulletin*, the Crown in effect admitted that all the rules contained therein were inefficient and had to resort to

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[1] For this example, see Robert S. Summers and Leigh B. Kelly, "'Economists' Reasons' for Common Law Decisions - A Preliminary Inquiry" (1981) 1 Oxford J. 213 at 216-217.

[2] In *Crestbrook Forest Industries Ltd. v. Her Majesty the Queen*, [1992] F.C.J. No. 150 (Appeal No. A-1034-91), the Federal Court of Appeal held that the Crown cannot use the information from a survey which it promised to be kept in confidence. The Crown would not be worse off, but the taxpayer got the benefit of the doubt.

court.[1] This would create economic chaos as nobody in the financial world could be certain what Revenue Canada had in mind, particularly in borderline cases. The wit of the Supreme Court justices prevented this from happening. However, in a situation where the *Interpretation Bulletin* is clearly in error, the taxpayer would still be unable to rely on it as the court retains its rights to interpret the statute. The Supreme Court, however, was not so imperialistic in taking an economic approach, in that it did not consider the *Interpretative Bulletin* as determinative. This is what Bruce Ackerman termed as "weak lawyer-economist" approach,[2] as its role is more of a pervasive nature.

The second point decided by the Supreme Court is simply a case of economic necessity. The Crown had conceded that salaries and wages can be classified as personal property, but the basis of taxation is a person's taxable income and that such taxable income is not personal property but rather a concept that results from a number of operations. Income is an accumulation of wealth in economic terms, whether it is taxable income or not.[3] As a matter of economic reality,

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[1] Paul Rubin, "Why is the Common Law Efficient?" (1977) 6 J. Legal Stud. 51.
[2] Bruce A. Ackerman, "Law, Economics, and the Problem of Legal Culture" (1986) Duke L.J. 929.
[3] The Supreme Court of Illinois case, *Bachrach v. Nelson*

the result of direct or indirect taxation on personal property would be the same. The Supreme Court has taken a "strong lawyer-economist" approach in that it considered that the only appropriate forms of legal argument are those that are acceptable to economists,' as the court made it clear that "a tax on income is in reality a tax on property itself."[2]

Her Majesty the Queen v. Savage

The Fact

Mrs. Savage, a research assistant of Excelsior Life Insurance Company, took three Life Office Management Association courses. These courses were designed to provide a broad understanding of the modern life insurance industry. The courses were voluntarily taken by Mrs. Savage to improve her knowledge. As a result of passing the examination, she received $300 from her employer ($100 per course). Such a benefit was available to all employees in accordance with the company's policy.

The Supreme Court held that the amount received was a benefit from employment because it was made by Mrs. Savage

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[3](cont'd) 1932), 182 N.E. 909, was considered by the Supreme Court of Canada. In that case, the Supreme Court of Illinois stated that the overwhelming weight of judicial authority holds that taxable income is personal property.
' Ackerman, op.cit., p.929.
[2] at p.38.

as an employee. In accordance to *Nowegijick v. Her Majesty the Queen*, the words "in respect of" are to be given the widest possible scope.[1] The payment was in respect of her employment because the employee took courses to improve her knowledge and efficiency in the company business and for better opportunity of promotion. That sum, however, was a prize for achievement in a field of endeavour ordinarily carried on by the taxpayer, within the meaning of Paragraph 56(1)(n) of the *Income Tax Act*. The word prize has to be construed in the context of the other words of the *Act* which give it colour, meaning and content. Accordingly, The Crown's appeal was dismissed.

Analysis

In this case, the court made it clear that any material acquisition which confers an economic benefit on the taxpayer and does not fall within an exempted category is considered as income.[2] The court agreed with Judge Evans in *Regina v. Poynton*.[3] This falls within the economist's definition of income as "the money value of the net accretion to one's economic power between two points of time."[4] This is another example that the Supreme Court has

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[1] op.cit. at p.440.
[2] op.cit. at p.441.
[3] [1972] 3 O.R. 727 at 738.
[4] John A. Kay and Mervyn .A. King, *The British Tax System* (Oxford: Oxford University Press, 1983), p.212.

taken a "strong lawyer-economist" approach.[1]

C. Supreme Court Tax Cases in 1984

In 1984, the Supreme Court of Canada released two cases related to tax matters. One of the cases was concerned with administrative process and constitutional law rather than tax law. In that case, *James Richardson & Sons, Ltd. v. M.N.R.*,[2] the Supreme Court had to decide whether the investigative power of the Minister of National Revenue under the Section 231(3) of the *Income Tax Act* is *ultra vires* to the *Charter*.[3] The second case, *Stubart Investments Ltd. v. Her Majesty the Queen*,[4] is a case of major significance and is regarded as "the straw that broke the camel's back and provided the impetus for the enactment of the General Anti-Avoidance Rule."[5] As discussed,[6] this case recognized economic goal in tax policy.

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[1] This decision, however, has been reversed substantially by subsequent amendments to Paragraph 56(1)(n) of the *Income Tax Act*.
[2] [1984] 1 S.C.R. 614.
[3] T.E. McDonnell and R.B. Thomas, "Restricting Third Party Demands for Information" (1984) 32:4 Can. Tax J. 745-748.
[4] [1984] 1 S.C.R. 536.
[5] Vern Krishna, *The Fundamentals of Canadian Income Tax* (Toronto: Carswell, 3rd edn. 1989), p.833.
[6] Supra, pp.21 and 25.

Stubart Investments Ltd. v. Her Majesty the Queen

The Fact

The taxpayer company sold its assets of a successful business to a sister subsidiary which had incurred substantial losses so that the taxpayer's profits could be offset by the losses. The taxpayer admitted that the sole purpose was to absorb its sister subsidiary's otherwise unusable losses with a resulting reduction in tax payable. It was agreed that the taxpayer carried on that business of the subsidiary and paid the net income to the subsidiary annually. The original intention was to transfer that business back when no losses could be offset. The whole transaction was well documented and no impropriety had ever been suggested. Revenue Canada disallowed this transaction and contended that a business purpose was required.

On the surface, the Supreme Court appears to have taken an economic analysis approach in allowing the appeal of the taxpayer.' It went on to draw up certain guidelines, and confirmed that the strict interpretation approach could still be applied unless *inter alia* the transaction is legally ineffective, incomplete or a sham. Moreover, the formal validity of a transaction has to give way to clear legislative intent and the object and spirit of the *Act*.

' Supra, pp.21 and 25.

Analysis

Achieving an economic objective is to pay the minimum amount of tax through proper planning whether the transaction or series of transactions would serve a business purpose. Although the decision of this case was viewed by some as providing an opportunity for a wealthy corporation to avoid tax through complex tax planning,[1] it nevertheless followed the classical British principle emanated in *Commissioner of Inland Revenue v. The Duke of Westminster*[2] that every man is entitled to order his affairs so as to attract the minimum amount of tax.[3]

The ruling of this case would make economic sense as proper business planning requires certainty. The *bona fide* purpose requirement of the General Anti-Avoidance Rule under Section 245 of the persent *Income Tax Act* is far from satisfactory. However, a review of three cases concerning the general anti-avoidance rule under the pre-1988 Section 245 of the *Income Tax Act* has shown that the Federal Court of Appeal did not support Revenue Canada's interpretations of this section.[4] These are the only cases dealing with the

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[1] David B. Debenham, "The Winds of Taxation: Stubart Investments Ltd. v. the Queen" (1986) 51 Sas. L.Rev. 292-310.
[2] [1936] A.C. 1, 19 T.C. 490, 51 T.L.R. 467 (H.L.).
[3] R.B. Thomas, "The Business Purpose Test - Not in Canada, Thank You!" (1984) 32:3 Can. Tax J. 529 at 531.
[4] *Her Majesty the Queen v. Irving Oil Ltd.*, [1991] F.C.J. No.133 (F.C.A.); *Her Majesty the Queen v. Kieboom*, [1991]

pre-1988 Section 245 and Revenue Canada was unsuccessful in persuading the court that there was an absence of *bona fide* business purpose or that the transactions were artificial.

The Supreme Court, however, only ascertained that Parliament employed economic policy objectives in income taxation. Once the intention of Parliament was ascertained, the Supreme Court did not wish to analyse the matter further. It did not question what economic policy objectives Parliament intended. Neither did it address the issues of efficiency nor provide the other side of the argument. Although proper tax planning would be efficient for running a business, it may also be argued that the time, money and effort would be better spent in plants and equipment rather than in "paper entrepreneurialism".[1] One cannot from this decision suggest that the Supreme Court has taken an economic analysis approach.

D. Supreme Court Tax Cases in 1985

In 1985, three tax cases of major public importance were heard by the Supreme Court of Canada. The first case, *Blais v. M.N.R.*,[2] was regarding excise tax matter. Another case, *Johns-Manville Canada Inc. v. Her Majesty the*

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[1](cont'd) F.C.J. No.637 (F.C.A.); *Laxton v. Her Majesty the Queen*, [1989] F.C.J. No.502 (F.C.A.).
[1] Debenham, p.292.
[2] [1985] 1 S.C.R. 849; [1983] 48 C.B.R.(N.S.) 98.

Queen,[1] involved the distinction made between income and capital under the *Income Tax Act*. The last tax case of the year was *Her Majesty the Queen v. Imperial General Properties Ltd.*[2] In this case, the court had to decide who was in control of the corporation under the *Income Tax Act*. Again, in determining the value of the shares, economic analysis is inevitable.

Blais v. M.N.R.

The Fact

A trustee in bankruptcy acquired the right to sell goods which had been purchased by the bankrupt company, which was licensed under the *Excise Tax Act* as a wholesaler. At the time of bankruptcy, the company had on hand goods brought or imported under licence and having a value of $184,037. After a call for tenders, the trustee sold those goods to a person not licensed under the *Act* for a price of $57,000. Revenue Canada claimed sales tax from the trustee computed on $184,037. The trustee paid under protest.

The Quebec Court of Appeal held that the tax was imposed, levied and collected on goods sold, even though it is computed on the duty paid value or the purchase price thereof. Accordingly, the company did not incur liablilty to

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[1] [1985] 2 S.C.R. 46.
[2] [1985] 2 S.C.R. 46.

pay excise tax under Section 27(1) of the *Act* and the trustee was liable to pay the excise tax under Section 27(3) of the *Act*. Therefore, the tax was not a claim provable in bankruptcy. However, the amount could be deducted from the proceeds of sale as an expense of administration. The trustee appealed.

The Supreme Court upheld the full text of the judgment of the Quebec Court of Appeal. This case is a simple interpretation of the *Excise Tax Act* and provides very little room for legal argument. It did, however, make its way to the Supreme Court of Canada.

Analysis

The collection method under the *Act* is intended for economic efficiency. An alternative approach would have been for the licensed wholesaler to pay Revenue Canada and then obtain a refund when it is evident that the licensed wholesaler has no obligation to pay the excise tax. However, this point has not been argued as the interpretation of the legislation is straightforward. The court has no need to address the issue of economic analysis.

Johns-Manville v. Her Majesty the Queen

The Fact

The taxpayer company had to keep on purchasing land for the expansion of its mining operations. In the instant case, it did so because it wanted to maintain the slope of the mine to prevent the land from sliding into the open pit. Revenue Canada considered such expenditures as being on account of capital.

In a unanimous decision, the Supreme Court held that the expenditures were deductible as current expenses incurred *bona fide* in the course of day-to-day operations.

Analysis

This case has been criticized, in that it failed to follow a defined framework for analysis and that it failed to provide a clear analysis of the common law tests.' Accordingly, it should not have any broad application. A detailed analysis of the case suggests that the court is just short of stating that its decision is one of economic policy. It is more a case of economic viability than anything else.

Common sense suggests that the above expenditures incurred by the taxpayer were on account of current

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' Catherine A. Brayley, "Income or Capital - The Spin of a Coin?" (1986) 8 Supreme Court L.Rev. 405 at 429.

expenses.' As Justice Estey observed, they formed "an easily discernible, more or less constant element and part of the daily and annual cost of production" and "the land had acquired no intrinsic value." According to the Statement of Claim, they were made "[i]n order to achieve both safe and economic mining of the ore." They did not accumulate any wealth to the capital account, but rather served to enhance the efficient operation of the mine. These views of the Supreme Court have never been addressed by the critics.

The Queen v. Imperial General Properties Ltd.

The Fact

The voting shares of the taxpayer corporation were owned by two groups equally, with equal voting power. One group holds 90 common shares and the other group holds 10 common shares and 80 preferred shares. Therefore, neither group could be said to have the control of the corporation since neither group had the power to elect the majority of the directors. The corporation could be wound up on a motion voted by 50 per cent of those with voting rights. In the event of a winding-up, the preferred shares of the corporation were entitled to par value of their shares and

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' Vern Krishna, "Developments in the Law of Income Taxation: The 1985-1986 Term" (1987) 9 Supreme Court L.Rev. 487 at 489.

any residue would go to the common shareholders.

The Supreme Court held that control was not surrendered on the issuance of the preferred shares. The group that was entitled to receive the economic value of the corporation also controlled the corporation for the purpose of the *Income Tax Act*.

Analysis

Justice Estey, speaking for a majority of the court, said "the court is not limited to a highly technical and narrow interpretation of the legal rights attached to the shares of a corporation." The court departed from a technical approach toward a wider economic view of the structure.[1] The court considered the economic substance of the relationship between the two groups and the corporation, rather than the form.[2] It has been suggested that one should not "simply and mechanically arrange corporate share structures and ignore their underlying economic substance."[3] The Supreme Court said that it would apply this new economic approach in the future.[4]

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[1] Krishna, op.cit., p.492.
[2] An example of where this approach is legislated is found in Section 256 of the *Income Tax Act*, where the court is required to look at the relationship between associated corporations.
[3] Krishna, op.cit., p.492.
[4] The majority in the Supreme Court stated: "We were also invited by counsel for the respondent to consider other combinations of share interests and to consider those combinations in the light of varying economic circumstances

The Supreme Court, however, made it clear it only dealt with the economic circumstances of the tax years in question. Accordingly, the *de facto* control would very much depend upon the condition of the company from time to time. The minority of the Supreme Court expressed concern about the uncertainty of the "test of *de facto* control based on an evaluation of *de jure* rights in different corporate contexts and under different economic and business conditions." The notion of uncertainty should be dismissed as the economic value can be simply determined by the application of the economic reality test from time to time. It is certain that the Supreme Court has approved the economic reality test, which in this case is a common sense approach.'

E. Supreme Court Tax Cases in 1986

Four cases involving the interpretation of the *Income Tax Act* were decided by the Supreme Court of Canada in 1986. In the first case, *Her Majesty the Queen v. Golden et*

'(cont'd) of a taxpayer. We are here concerned only with the corporate structure of the respondent in the tax years in question. The courts will deal with other combinations and circumstances if and when those circumstances do indeed come before the courts in future appeals."

' In approving the test of "economic substance", the majority of the Supreme Court said: "The application of the "control" concept, as earlier enunciated by the courts, to the circumstances now before the court is, in my view, the ordinary progression of the judicial process and in no way amounts to a transgression of the territory of the legislator."

al.,[1] the court had to decide whether the allocation of purchase price between the parties was unreasonable and to interpret the power of the Minister of National Revenue under Section 68 of the *Income Tax Act*. The second case dealt with the deduction of allowance payment in computing the income. In this case, *Gagnon v. Her Majesty the Queen*,[2] the court expressly took economic value into consideration. The third case is *Ensite Ltd. v. Regina*,[3] and the court had to consider whether interest from foreign investment income was used in the course of carrying on business. The last case, *Canadian Marconi v. Regina*,[4] was an appeal regarding whether income was from active business or from property.

Her Majesty the Queen v. Golden et al.

The Fact

The taxpayers sold in an arm's length transaction a plot of land containing apartment buildings for $5,850,000. The Agreement of Purchase and Sale expressly provided that of this total price $5,100,000 was allocated to land and $750,000 was allocated to "equipment, buildings, roads, sidewalks, etc." Pursuant to Section 68 of the *Income Tax*

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[1] [1986] 1 S.C.R. 209.
[2] [1986] 1 S.C.R. 264.
[3] [1986] 2 S.C.R. 509.
[4] [1986] 2 S.C.R. 522.

Act, Revenue Canada reassessed the respondents' allocation of proceeds with the result that substantial amounts of recaptured capital cost allowances were added to their incomes. The Federal Court of Appeal held that Section 68 of the *Act* had no application to this transaction.

The Supreme Court dismissed the appeal. The majority held that Section 68 of the *Income Tax Act* is applicable to the present transaction. The expression "something else" in the section does not refer only to something other than property. However, they upheld the decision of the Federal Court of Appeal and confirmed that the allocation of purchase price made by the parties was "reasonable" within the meaning of the section. The minority took the view that Section 68 of the *Act* has no application to this transaction.

Analysis

The majority was in the opinion that the expression "something else" in the section does not refer only to something other than property. They clearly took a new approach in statutory interpretation by following *Stubart*[1] and not confining to a literal interpretation of the *Income Tax Act* in the historical sense.[2] After considering the

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[1] Supra, p.75.
[2] D.G. Wentzell, "Section 68 - The Growl of a Paper Tiger" (1986) 34:2 Can. Tax J. 395-397; Krishna, "Developments in the Law of Income Taxation: The 1985-1986 Term" p.494.

broad definition of "property" in the *Act*, such an interpretation would substantially gut the section of all meaning and confine it to a minuscule part of commercial transactions.

The majority believed that it was unlikely that Parliament, in the 1972 amendments, intended to abandon the aim achieved by Paragraph 20(6)(g) of the *Income Tax Act* of 1952 and to enact a new section having very similar wording but no similar application. To be in harmony with the purpose of Section 68 of the *Act*, the expression "something else" must be given the widest meaning reasonably assignable, one which includes non-property as well as property items or classes of property. The majority, however, accepted that the allocation of prices was reasonable as it was made as a result of *bona fide* arms length negotiations, and the court would not substitute another set of figures for those the parties actually agreed to. In this case, no economic approach has been adopted by the court.

Gagnon v. Her Majesty the Queen

The Fact

Pursuant to a judgment of divorce, the taxpayer paid his former wife alimony of $360 a month to repay two

hypothecs and the municipal and school taxes affecting her immovable. The deductions claimed by the appellant for this amount were disallowed by Revenue Canada. This appeal is to determine whether the amounts paid by the appellant to his former wife are deductible under Subection 60(b) of the *Income Tax Act*, and in particular, whether these amounts are "allowances" within the meaning of that subsection.

The Supreme Court allowed the appeal. To qualify as an "allowance" within the meaning of Subsection 60(b) of the *Income Tax Act*, a sum of money must meet three conditions: (1) it must be limited and predetermined pursuant to a decree, order or judgment or a written agreement; (2) it must be paid for the maintenance of the recipient; and (3) it must be at the complete disposition of the latter. This third condition, which can be inferred from the case law, does not mean that the recipient can apply these amounts to certain types of expenses at her discretion and without being required to account for them. This condition will be met if the recipient is able to dispose of them completely for her own benefit, regardless of the restrictions imposed as to the way in which she disposes of them and benefits from them.

In the case at bar there is no doubt that the amounts paid by the appellant are "allowances" within the meaning of

Subsection 60(b) of the *Act*. The duty imposed on the former wife to apply these amounts to particular purposes does not affect the benefit she derived from them. These amounts are therefore deductible.

Analysis

The court has taken into account an academic analysis of the tax burden between former or separated spouses which suggested compensating the spouses for the lost economies of maintaining a single household.[1] It also considered the American jurisprudence[2] that a gain "constitutes taxable income when its recipient has such control over it that, as a practical matter, he derives readily realizable economic value from it." Applying this definition, the court concluded that the appellant's former wife could dispose of the amount completely and that she derived from them a "readily realizable economic value." The duty which she had to apply these amounts to particular purposes does not affect the benefit she derived from them. This case is significant in that the unanimous decision of the Supreme Court suggests a tendency in tax jurisprudence towards a concept of income that is in harmony with realizable

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[1] C. Dawe, "Section 60(b) of the Income Tax Act: An Analysis and Some Proposals for Reform" (1979) 5 Queen's L.J. 153.
[2] *Rutkin v. United States*, (1952) 343 U.S. 130, affirmed in *James v. United States*, (1961) 366 U.S. 213.

economic value.[1] Applying the economists' definition of income rather than using economic analysis, the Supreme Court has narrowed the range of exclusions from income.[2]

Ensite Ltd. v. Regina

The Fact

The taxpayer, which had to finance its plant in the Philippines with foreign currency in order to comply with Philippine law, became involved in an elaborate arrangement to minimize the risks of devaluation and currency controls. It made U.S. dollar deposits with the commercial banks, which then made peso loans in an equivalent amount to the appellant at its Philippine branch and in return received certificates of deposit for the U.S. dollar deposits which were then used to secure the peso loans. The certificates were "enforceable" against any branch of the commercial banks outside the United States. The taxpayer included the interest from its U.S. dollar deposits in the Philippines in the calculation of its "foreign investment income". In 1976, the appellant claimed a "dividend refund" under Paragraph 129(1)(a) of the *Income Tax Act*.

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[1] R.B. Thomas, "Deduction of Alimony and Maintenance Payments Have We Come Full Circle?" (1986) 34:4 Can. Tax J. 853-856; Krishna, "Developments in the Law of Income Taxation: The 1985-1986 Term" p.496.

[2] Krishna, ibid.

Revenue Canada reassessed the return and refused to recognize the interest as "foreign investment income", as defined in Paragraph 129(4)(b) of the *Act*, because it was "income from property used or held by the corporation in the year in the course of carrying on a business". The Federal Court Trial Division allowed an appeal from that reassessment but its judgment was overturned on appeal.

The Supreme Court dismissed the appeal. The test to distinguish income from carrying on a business from income derived from property is whether or not the property was used to fulfil a requirement which had to be met in order to do business, and not whether or not the taxpayer was forced to use a particular property to do business. The property must be truly employed and risked in the business and "risk" must mean more than a remote risk and more than a business purpose for the use of property. The threshold of the test is met when the withdrawal of the property would "have a decidedly destabilizing effect on the corporate operations themselves". The investment of profits from trade in order to achieve some collateral purpose is therefore distinguishable from an investment made in order to fulfil a mandatory condition precedent to trade. Here, the property was not for any collateral purpose but rather was employed and risked in the taxpayer's business in the most intimate

way. It was used or held in the business and fulfilled a mandatory condition precedent to trade.

Analysis

In this case, the U.S. dollar deposits were a direct result of business efficiency and it was employed and at risk in the taxppayer's business in the Philipines.[1] In doing so, the taxpayer minimized its risk in the foreign currency exchange. If the risk in the foreign currency exchange and in the governmental policy in the Philippines or in the type of business is small, the court could well have decided the other way.[2] Although economic risk was considered in this case, the court did not use any economic analysis to make its decision. It accepted the fluctuation of the peso and the uncertainty of governmental policy in the Philippines.

Canadian Marconi v. Regina

The Fact

The taxpayer owned and actively managed a large and profitable portfolio of short term interest bearing securities. The portfolio was created on the forced sale of

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[1] T.E. McDonnell, "Interest Income - Whether Income from Active Business or Income from Property" (1986) 34:6 Can. Tax J. 1431 at pp.1435-1437; Vern Krishna, "Developments in the Law of Income Taxation: The 1986-1987 Term" (1988) 10 Supreme Court L.Rev. 297 at 301-302.

[2] McDonnell, op.cit., 1436.

its broadcasting interests and was eventually to be liquidated in order to purchase a business similar to or complementary with the appellant's electronic equipment manufacturing business. For the taxation years 1973 through 1976 inclusive, the appellant claimed a tax credit in respect of the interest earned relying on Section 125.1 of the *Income Tax Act*. It maintained that this interest was part of its "Canadian manufacturing and processing profits", a portion of which is eligible for deduction under that section, because the interest received was income from an active business. Revenue Canada, in its re-assessments, held the interest income to be income from property and not from an active business. The taxpayer unsuccessfully appealed the re-assessments to the Federal Court Trial Division and the Federal Court of Appeal.

The Supreme Court allowed the appeal. In the case of a corporate taxpayer, case law has established a rebuttable presumption that income received from or generated by an activity done in pursuit of an object set out in the corporation's constating documents is income from a business. This presumption should apply because the taxpayer had a specific "investment business" object. The taxpayer was incorporated to do business, and there was no reason why any income it earned should not be considered as *prima facie*

income from a business. In making this determination, the relevant inquiry is not into the taxpayer's business strategy but rather into whether the taxpayer was in fact in the investment business. "Active business" is nowhere restricted to a manufacturing or processing business. If such restriction were intended, Parliament would have to express itself clearly to that effect.

Analysis

This is a straightforward case where the court took commercial reality into consideration.[1] A prudent business person would invest surplus working capital in marketable securities for efficiency[2] in accordance with the evidence supported by economic data. Although the Supreme Court did not expressly address this issue, economic reality dictates that the assets of the taxpayer would be depreciated if he did not invest them. However, such argument seems redundant as the common sense approach used by the Supreme Court is sufficient to render a logical decision in this case.

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[1] Krishna, "Developments in the Law of Income Taxation: The 1986-1987 Term" p.298.
[2] Ibid.

F. Supreme Court Tax Cases in 1987

In 1987, three cases involving tax matters were released by the Supreme Court of Canada. The only case of major importance to our analysis is *Her Majesty the Queen v. Phyllis Barbara Bronfman Trust*,[1] where the court affirmed the significance of economic reality. *Restaurant Le Clemenceau Inc. v. Drouin*[2] is a case regarding search and seizure authorized by the Deputy Minister of Revenue and is more of a constitutional law case than a tax case. The third case, *Regina v. Grimwood*,[3] is a case where the taxpayer failed to comply with the Minister of National Revenue's request to provide information under Subsections 231(3) and 238(2) of the *Income Tax Act*. It is not much of relevance to our analysis.

Her Majesty the Queen v. Bronfman Trust

The Fact

Rather than liquidating income-producing assets, the trustees of the trust elected to make capital allocations to the beneficiaries by borrowing money. The issue was whether the interest paid on loans was deductible. The trustees argued that had they sold the assets and then borrowed to

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[1] [1986] 1 S.C.R. 32.
[2] [1987] 1 S.C.R. 706.
[3] [1987] 2 S.C.R. 755.

replace the assets, they could have deducted the interest and the outcome would have been the same.

The Supreme Court held that funds must have been borrowed for the direct purpose of producing income. In commenting on the trend to depart from strict construction, the court considered it a laudable trend provided it is consistent with the text and purposes of the taxation statute. The court took the view that assessment of taxpayers' transactions with an eye to commercial and economic realities, rather than juristic classification of form, may help to avoid the inequity of tax liability being dependent upon the taxpayer's ability to have good tax advisors.

Analysis

This is a case where the court has approved economic reality but did not apply it.[1] However, the outcome of the case is contradictory. From an economic point of view, there is practically no difference between borrowing money for the purpose of directly earning income and preserving income-producing assets.[2] The departure from economic reality in its statutory interpretation reflects the concern of the court about the adverse consequences in allowing a

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[1] Supra, p.26.
[2] Krishna, "Developments in the Law of Income Taxation: The 1986-1987 Term" p.305.

deduction of interest expenses from the indirect use of funds.[1] As the acceptance of economic reality in this case would more likely favour only those who have income-earning assets, the court chose to interpret the *Income Tax Act* in conformity to the objective of achieving horizontal equity. This is a case where economic efficiency in the use of funds was considered by the court to be inequitable. Although some argued that wealthier taxpayers would arrange their borrowings to circumvent this ruling,[2] the court, nevertheless, made it more difficult for it to happen.

G. Supreme Court Tax Cases in 1988

The year 1988 can be considered as a year of no significance for tax cases determined by the Supreme Court of Canada. Only two cases related to tax matters were decided by the Supreme Court. The first case, *A.L. Cox et al. v. Attorney General of Canada*,[3] was a constitutional case regarding Section 232 of the *Income Tax Act*. The second case, *Mattabi Mines Ltd. v. Ontario (M.N.R.)*,[4] dealt with tax administration by the provincial government as to whether it should be consistent with federal practice. Although this case is not an interpretation of the federal

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[1] Ibid.
[2] Ibid.
[3] [1988] 2 C.T.C. 365; 88 D.T.C. 6494.
[4] [1988] 2 S.C.R. 175.

Income Tax Act, it nevertheless demonstrates that the Supreme Court seldom takes economic reality into consideration although it has an opportunity to do so.

Mattabi Mines Ltd. v. Ontario (M.N.R.)

The Fact

In 1971 the federal government announced that the three-year tax exemption for new mining developments would end after 1973. The Ontario government made a similar decision retroactively in April 1974. The taxpayer was therefore liable for both federal and provincial taxes in 1974. To reduce its provincial taxes for that year, the taxpayer claimed an investment tax credit pursuant to Subsection 106(1) of the *Corporations Tax Act, 1972*. Although this credit was normally only available for the fiscal year in which the machinery and equipment was "acquired and used", Subsection 106(4) permitted it to be carried forward if the taxpayer had incurred a "net loss" in previous taxation years.

In order to become eligible for the tax credit, the taxpayer filed with its 1974 income tax return, claiming the credit, an amended return for the fiscal year 1971 claiming a loss of $100 by adding a capital cost allowance claim of that amount to the previously reported income of "nil". The

taxpayer made an identical claim for 1972. The federal authorities accepted the 1971 amended return, but the respondent did not and consequently disallowed the claim for a tax credit. The respondent also refused to accept two further amendments which would also have created a "net loss" for the taxpayer in the 1971 and 1972 taxation years. This appeal was to determine whether the taxpayer can claim an investment tax credit for its 1974 taxation year.

The Supreme Court dismissed the appeal. The only thing that matters is that the expenditures were a legitimate expense made in the ordinary course of business with the intention that the company could generate a taxable income some time in the future. The taxpayer therefore met the qualifying provisions in Subsection 106(1) of the *Act* and qualified for the tax credit for 1971 -- the year in which the expenditures were made.

However, the respondent's refusal to accept the taxpayer's amended tax return for 1971 prevents it from taking advantage of the tax credit for the 1974 fiscal year. Although the taxpayer was entitled by the federal *Interpretation Bulletin IT-112* to revise the capital cost allowance for 1971 and was required by the *Ontario Reg. 350/73* to submit a similar revision to the province, there was nothing in the *Act*, the *Regulation* or any provincial

Interpretation Bulletin which obliged the respondent to accept the taxpayer's revised return. The federal authorities accepted the revision pursuant to their own practice but there was no reason for them not to do so since the amendment was made to the federal return solely for the purpose of making the same amendment provincially.

Analysis

The retroactive abolition of the tax exemption by the province could not *per se* constitute a reason for interpreting the *Regulation* so as to compel the respondent to accept the amendment. Although not considered by the court, any retroactive act would create uncertainty, and, hence, adversely affect efficiency. This, however, has not been sufficient to stop the courts from upholding retroactive legislation in proper circumstances.

The taxpayer contended that the federal and the provincial authorities made an error when they accepted its choice to capitalize interest payments despite its failure to submit the appropriate documents for such election. The respondent was entitled to waive strict compliance with the statute and treat the taxpayer's reporting of the item in its corporations tax return for 1972 as an election. This technical oversight could not be used to demand what was effectively a reopening and revision of the 1972 return long

after the time for assessment, objection and appeal had passed. Finally, the taxpayer was not entitled to reopen its 1974 return to deduct additional capital cost allowance given the disallowance of the investment tax credit. There was no statutory provision to permit these reopenings.

Although the Supreme Court did not say so, it would be be economically inefficient to allow a reopening after a lengthy period of time and for a trivial error. It allowed the province to retroactively change the rule to the taxpayer's disadvantage and did not allow the taxpayer a corresponding right. Accordingly, efficiency prevails over equity. However, neither *Pareto-superior* nor *Kaldor-superior* reasons are applicable in the instant case. The provincial rules changed and were applied retroactively. The taxpayer stood to lose and the respondent's gains could not compensate the taxpayer's losses. Economic reality was not explicitly considered by the court. Although not expressly stated, the Supreme Court followed its previous decision in *Her Majesty the Queen v. Bronfman Trust*,[1] and was reluctant to give consideration to the taxpayer who could afford to have high-priced tax planners.[2]

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[1] Supra.

[2] In the *Bronfman* case, the Supreme Court said, "..... the inequity of tax liability being dependent upon the taxpayer's sophistication at manipulating a sequence of events to achieve a patina of compliance with the apparent prerequisites for a tax deduction."

H. Supreme Court Tax Cases in 1989

Two cases regarding provincial tax powers were decided by the Supreme Court of Canada in 1989. The first case, *Canadian Pacific Air Lines Ltd. v. British Columbia*,[1] was decided upon jurisdictional grounds, and the second case, *Air Canada v. British Columbia*,[2] involved the right to liberty under the *Canadian Charter of Rights and Freedoms*. In addition, the Supreme Court decided two cases related to tax grossing-up in a personal injury damage award. These two tort cases are *Watkins v. Olafson*[3] and *Scarff v. Wilson*.[4] These cases are not related to the *Income Tax Act*, but might serve as a guide for investigating the tendency of the Supreme Court in tax matters.

Canadian Pacific Air Lines Ltd. v. British Columbia

The Fact

The *Social Service Tax Act* of British Columbia provided for a tax on the purchase of tangible goods purchased in British Columbia. The tax was applied to aircraft and aircraft parts and was calculated, in accordance with different formulae negotiated with each airline, on the ratio of miles travelled by the aircraft in airspace over

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[1] [1989] 1 S.C.R. 1133.
[2] [1989] 1 S.C.R. 1161.
[3] (1989), 61 D.L.R. (4th) 577; [1989] 6 W.W.R. 481.
[4] (1989), 61 D.L.R. (4th) 749; [1989] 6 W.W.R. 500.

British Columbia to the total miles travelled. The formulae had no statutory base. All aircraft and parts were bought outside the province and were used to meet the airline's operational needs on flights forming part of a more comprehensive international and interprovincial service. The aircraft were in constant use. The airlines also collected this tax in respect of in-flight liquor sales made to passengers in airspace over British Columbia if the flight originated or terminated in, or connected two points within, the province.

The Supreme Court held that the airline's first appeal relating to taxes on the aircraft and parts should be allowed and the province's cross-appeal relating to taxes on in-flight sales of alcoholic beverages should be dismissed. The majority held that the predominant purpose of the *Social Service Tax Act* was to impose a retail tax payable by the ultimate consumer of the goods in the province.

The second appeal by Air Canada was allowed as regards the amount claimed for taxes unlawfully collected in respect of its aircraft and aircraft parts. The majority held that since the issue regarding the applicability of the *Act* had now been decided in Air Canada's favour in the first appeal, there was no reason why it should be refused recovery. The fact that Air Canada paid the money on the basis of a

mistake of law does not preclude recovery. But Air Canada cannot recover the money paid by its passengers for the tax on alcoholic beverages because it was acting as an agent to collect it under the *Act*.

Analysis

The Supreme Court took the view that the provision relating to tax on goods brought into the province for consumption by the ultimate consumer was to serve as a supplementary provision to guard against avoidance of the purchase tax by a consumer's purchasing goods outside the province. It was aimed at goods brought into the province on a permanent basis. It had no application to aircraft regularly flying in and out of the province. If it did so apply, it would, if it were to be imposed by all provinces on interprovincial airlines, place a much heavier burden on these entities than on local airlines and other businesses. An intention on the part of the Legislature to enact a measure having such discriminatory potential should not be lightly assumed. The formulae which were used to alleviate any unfair tax burden on the airlines were without statutory basis and so did not bind the taxing authorities. Although the court did not say so, the logic leading to the above decision is in fact a consideration of economic efficiency.

As to the second appeal, the Supreme Court decided that Air Canada cannot recover the money paid by its passengers for the tax on alcoholic beverages. It was simply acting as an agent to collect it under the *Act*. In other words, Air Canada did not have anything to lose, the passengers would be indifferent as to the refunds, and the administrative costs to refund would be economically inefficient, but British Columbia stood to gain. No practical inequity would have resulted from this decision, although passengers paid more than they should have. The court follows the *Pareto-superior* reasoning in that no one would be "actually" worse off and at least one party would be better off. The *ratio* of the following case illustrates these points. It is quite obvious that the Supreme Court adopted an economic approach in its analysis.

Air Canada v. British Columbia

In this case, the Supreme Court held that the development of the law of restitution had rendered otiose the distinction between mistakes of fact and mistakes of law. It stated that restitutionary principles, however, preclude recovery where the plaintiff has suffered no loss. If the taxing authority retains a payment to which it was not entitled, it will be unjustly enriched but not at the

taxpayer's expense if the economic burden of the tax has been shifted to others. Generally, it is preferable to leave the enrichment with the tax authority instead of putting the judicial machinery in motion for the purpose of shifting the same enrichment to the taxpayer. The law of restitution is not intended to provide windfalls to plaintiffs who have suffered no loss. Rather, its function is to ensure that where a plaintiff has been deprived of wealth that is either in his possession or would have accrued for his benefit, it is restored to him. The taxpayer must show that it bore the burden of the tax to make out its claim. What the province received was relevant only in so far as it was received at the taxpayer's expense.

Apart from this, while the principle of unjust enrichment can operate against a government to ground restitutionary recovery, where the effect of an unconstitutional or *ultra vires* statute is in issue, special considerations operate to take the case out of the normal restitutionary framework and require a rule responding to the underlying policy concerns specific to this problem. The rule is against recovery of *ultra vires* taxes, at least in the case of unconstitutional statutes.

The policies that underlie the above rule are numerous. Chief among these are the protection of the treasury, and a

recognition of the reality that if the tax were refunded, modern government would be driven to the inefficient course of re-imposing it, either on the same or on a new generation of taxpayers, to finance the operations of government. It could lead to fiscal chaos, particularly where a long-standing taxation measure is involved. The tax here is of broad general application and has been imposed for decades.

Exceptions may exist where the results would be unjust or oppressive in the circumstances. Before a payment will be regarded as involuntary there must be some natural or threatened exercise of power possessed by the party receiving it over the person or property of the taxpayer for which he has no immediate relief other than to make the payment. The rule against the recovery of unconstitutional and *ultra vires* levies is an exceptional rule, and should not apply where a tax is extracted from a taxpayer through a misapplication of the law. A case can be made against the rule in that it would result in a very dangerous precedent: government taxes as it wishes without proper authority and then hides behind the rule when challenged, as there is no penalty for breaking the law.

Watkins v. Olafson

The Fact

The appellant, who was a passenger in a van operated by Olafson and owned by Aitkenhead, brought an action in tort against them and the provincial government following an accident that occurred on a stretch of highway that had been under construction. The trial judge awarded a lump sum payment. This payment included damages for loss of earning capacity both to the date of trial and for the future, damages for future care as initial outlay and for ongoing care, and an amount for a financial management fee.

At issue here was *inter alia* whether an allowance should be made for the effect of taxation in calculating the cost of future care. The Supreme Court stated that an allowance should be made for the impact of taxation on the award for cost of future care where the evidence supports it, as it does here.

Analysis

The theory of "grossing-up" is that an additional sum should be awarded to compensate for the tax that will accrue on the interest portion of the award. Acceptance of the right to an allowance for the impact of taxation on the award for future cost of care does not effect a major change in the established law or deprive either party of an

established right, permitting the court to rule on the matter. A strong case can be made for taking the impact of taxation into account, for the award will otherwise prove insufficient to meet the plaintiff's projected needs. Calculating an allowance for taxation is not so inherently speculative or so excessively difficult as to warrant not taking taxation into account.

The Supreme Court ventured into economic water by citing "[r]ecognition of the effect of taxes, no matter how difficult to calculate, seems essential if awards are to be fair to the plaintiff."[1] The Supreme Court did not accept that the computation of future taxation would be speculative.[2] It resorted to economic data provided by an actuary and two chartered accounts. However, this case falls short of applying any economic theories by the court other than accepting expert opinions.

Scarff v. Wilson

The Fact

The only issue on this appeal is whether it is open to the court to take the impact of taxation into account in

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[1] Professors Feldthausen and McNair, "General Damages in Personal Injury Suits: The Supreme Court's Trilogy" (1978) 28 U.T.L.J. 381.

[2] Jeanne Watchuk, "Tax Gross-ups Revisited" (1989) 37:6 Can. Tax J. 1486-1490.

calculating the amount of the award for future care. The Supreme Court followed its previous decision set out in *Watkins v. Olafson* above[1] and allowed the appeal.

I. Supreme Court Tax Cases in 1990

The Supreme Court released its decisions on four cases relating to tax matters during 1990. The first two cases, *R. v. McKinlay Transport Ltd.*[2] and *Knox Contracting Ltd. v. Canada*,[3] were constitutional cases regarding Sections 231 and 239 of the *Act* on the investigative and search and seizure powers of Revenue Canada respectively. The third case, *Her Majesty the Queen v. Fries*[4] concerned the computation of income. The fourth case, *McClurg v. Her Majesty the Queen*[5] touched the attribution rule under Subsection 56(2) of the *Income Tax Act*, but the Supreme Court decided this case upon the principles of company law.

Her Majesty the Queen v. Fries

The Fact

The taxpayer was an employee of the Saskatchewan Liquor Board. He was paid $800 as strike benefits for striking for

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[1] [1989] 2 S.C.R. 750.
[2] [1990] 1 S.C.R. 627.
[3] [1990] 2 S.C.R. 338.
[4] [1990] 2 S.C.R. 1322.
[5] [1990] 3 S.C.R. 1429.

his union, which supported other striking unionists. This amount would be equivalent to his regular take-home pay net from income for the period he was on strike. The Federal Court of Appeal held that the strike pay should be taxable under Section 3 of the *Income Tax Act*, and rejected Paragraph 3 of the *Interpretation Bulletin IT-334R* which considered strike pay as generally not taxed as income.

However, the Supreme Court allowed the appeal and stated the strike pay in this case did not come within the definition of "income ... from a source" within the meaning of Section 3 of the *Act*. The court gave the benefit of the doubt to the taxpayer.

Analysis

The decision provided by the Federal Court of Appeal was not inconsistent with *Nowegijick v. Her Majesty the Queen*,' although it rejected the authority of the *Interpretation Bulletin*. The definition of income under Section 3 of the *Act* is not exhaustive, and strike pay is neither windfall gains nor gifts from income which are excluded under the common law rule. Moreover union dues are deductible as expenses from employment income under Subparagraph 8(1)(i)(iv) of the *Act*.

' Supra, p.70.

Income is defined by economists as "the money value of the net accretion to one's economic power between two points of time."[1] The fact that the strike pay was equivalent to the taxpayer's net income should be immaterial as to its inclusion from income as he was doing a different type of job with a different value. Unfortunately, the Supreme Court only delivered a brief oral judgment which did not provide the reasons for its decision. Assuming the Supreme Court did not consider an economic approach, it should have followed the logical approach of the Federal Court of Appeal. Although the Supreme Court followed the trend to narrow the "source" to the traditional sources of income as decided by the Federal Court of Appeal in *Her Majesty the Queen v. Cranswick*,[2] the present case might have been decided on political grounds.[3]

McClurg v. Her Majesty the Queen

The Fact

The respondent and a business associate formed a new corporation to acquire a business, and they constituted the Board of Directors. They each subscribed for 400 voting

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[1] Richard Haig, "The Concept of Income - Economic and Legal Aspects" in Richard Haig ed., *The Federal Income Tax Act* (New York: Columbia University Press, 1921), p.59.
[2] [1982] C.T.C. 69, 82 D.T.C. 6073 (F.C.A.).
[3] Vern Krishna, *The Fundamentals of Canadian Income Tax*, p.179.

shares in class A. Each of their wives subscribed for 100 non-voting shares in class B. The par value of each of the shares in both classes was $1. According to the Articles of Incorporation, the directors can at their discretion pay dividends on either class. In the tax years in question, dividends were declared on the class B shares and no dividends were declared on class A shares.

Revenue Canada took the view that the payment of dividends was caught by Subsection 56(2) of the *Income Tax Act* as it should be attributed to the income of the respondent. It argued that the provisions in the Article of Incorporation that allowed the directors to declare dividends on only one class of shares violated corporate law. The Supreme Court held that the common law principle that the decision to declare a dividend lies within the discretion of the Board of Directors could be included in the Articles of Incorporation.

Analysis

This case turned out to be more a matter of corporate law than tax law.[1] This case was decided with a four-to-three split. While the veil of a corporation has been deeply entrenched in corporate law under the rule in

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[1] T.E. McDonnell, "Tax Planning: Split(ting) Decision - Part I" (1991) 39:2 Can. Tax J. 309.

Salomon v. Salomon & Co.,[1] the question in this case should be whether the court was willing to lift the veil of the corporation in the absence of legislative guidelines in tax avoidance cases. Unfortunately, the minority of the Supreme Court in this case focussed on the fundamental weakness of the "discretionary clause" under the common law rather than the circumstances in unveiling a corporation.

The Supreme Court approved the "object and spirit" test of *Stubart Investments Ltd. v. Her Majety the Queen*,[2] and the "commercial reality" test of a taxpayer's transaction in *Her Majesty the Queen v. Bronfman Trust*.[3] We have analysed these two cases earlier in this chapter.[4] However, in considering "the economic and commercial reality of the taxpayer's actions" in the present case, the Supreme Court held that Subsection 56(2) of the *Act* could not "have been intended to cover benefits conferred for adequate consideration in the context of a legitimate business relationship." It seems that the Supreme Court applied *Stubart* incorrectly by stating that the present transaction was not "constructed as to create a false impression in the eyes of a third party, specifically a taxing authority." In the instant case, the "economic and commercial reality" is

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[1] [1897] A.C. 22 (H.L.).
[2] Supra.
[3] Supra.
[4] Supra, pp.76 and 95.

to enable the taxpayer to hide under the veil of the corporation.

J. Supreme Court Tax Cases in 1991 and 1992

The only tax case in 1991 was a provincial case concerned with the status of the trustee appointed under a provincial *Special Corporate Powers Act*.[1] This case, *Societe Nationale de Fiducie v. Quebec (Deputy Minister of Revenue)*,[2] has no relevance to the federal *Income Tax Act*. The Supreme Court delivered a brief one-paragraph oral judgment to conclude the only tax case of the year.

In 1992, up to 9 April, the Supreme Court had not delivered any decisions on tax matters. The small number of cases in tax matters considered by the Supreme Court tend to suggest that it rarely grants leave to appeal on tax matters, or that there are very few applications for leave to appeal. An analysis of the leave granted by the Supreme Court between 1983 to 1988 indicates that out of 49 applications for leave to appeal in federal tax matters, only 6 applications were granted.[3] And, a number of them, as mentioned earlier, are more appropriately matters under the

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[1] R.S.Q., c. P-16.
[2] [1991] 1 S.C.R. 907.
[3] "Leave to Appeal Applications" (1986-89) 8-11 Supreme Court L.Rev. 391-394, 474-477 370-373 and 392-395 respectively.

Canadian Charter of Rights and Freedoms than tax matters. During the same period, out of 543 applications for leave to appeal on the grounds of the *Charter*, 191 applications were granted.[1] Between the 1985-1986 and 1987-1988 terms, only 2 applications for leave to appeal were granted out of 39 applications for leave to appeal from federal and provincial tax matters.[2] This suggests that the priority of the Supreme Court is *Charter* cases than tax cases.

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[1] Ibid.
[2] Ibid.

V. Conclusion

In the preceding chapter, we have analysed Supreme Court tax cases for a period of ten years. This period is particularly important for predicting future trends of the Supreme Court. It is a period when the law and economics movement was developing in the United States.

According to *Stubart* and *Bronfman Trust*, it is debatable whether the recommendation of the Carter Commission, that if conflicts arose equity should prevail over efficiency and simplicity, has been observed.[1] In *Imperial General*, *Gagnon*, *Walkins v. Olafson*, and *Scarff v. Wilson*, the Supreme Court accepted economic value in rendering its decision. In *Nowegijick* and *Savage*, it took the economists' definition into consideration, although it did not expressly say so. However, none of the last five cases involved any economic analysis of the facts.

In *Nowegijick*, the Supreme Court took a *de facto* approach in considering the authority of the *Interpretation Bulletin*. However, in *McClurg*, it took a *de jure* approach, the result of which led to inequity although the Supreme Court stated that it applied "economic and commercial reality" to the case. In *Fries*, the Supreme Court rejected

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[1] *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1966), Vol.1, p.3.

that strike pay should be taxable and the circumstances of the case suggest that it would be for political reality more than anything else.[1] However *Fries*, *Mattabi*, and *McClurg* are the only three tax cases in the above period for which the Supreme Court deserved some criticism.

In *Johns-Manville*, *Ensite*, *Canadian Marconi*, and *Mattabi*, the Supreme Court took a logical approach by reason of efficiency. In *Canadian Pacific* and *Air Canada*, the reason of the court can be explained by *Pareto* analysis, although the court stopped short of providing such terminology. All these cases suggest that the Supreme Court takes a *de jure* approach, and the application of economic analysis is merely incidental. There is evidence to suggest the presence of "implicit economic logic"[2] in most Supreme Court cases although the justices did not use economic analysis to justify their decisions.

Only two cases decided by the Supreme Court during the above period, *Blais* and *Golden*, did not involve "economics" at all. Perhaps, the application of economics is so deeply entrenched in all aspects of our daily life that we cannot avoid it. The question is one of frequency and acceptance. The tax cases in which economic analysis was discussed did

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[1] Supra, p.112.
[2] Supra, p.54.

not contribute much to scholarship and judicial theory in the area of economics and tax law, as the Supreme Court has neither provided a theoretical analysis of the economic theories behind its decisions nor defined what it meant by "economics". However, the Supreme Court has never indicated that it will reject economic analysis, nor has it ruled against being asked to "fish in the most troubled socio-economic waters."[1] One can only speculate from the analysis of the cases what the Supreme Court has in mind.

There are two factors that may explain why the Supreme Court acted the way it did. The first factor is that legal scholarship in economic analysis is developing in Canada.[2] On a positive side, there is a growing interest in fundamental research in Canada.[3] However, the boundaries between the legal scholar's study of the tax law and the work of sociologists, economists, or political scientists writing about tax law still has to be sorted out.[4]

In the United States, the University of Chicago's law school is a leading proponent of law and economics, and their scholarship reached its height when its faculty member, Ronald Coase became the first legal scholar to recieve a Nobel Prize in economics. A few justices of the

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[1] Supra, p.58.
[2] Supra, p.1n.
[3] Ibid.
[4] Ibid.

United States Court of Appeal were appointed directly from the Chicago law faculty.[1] There is no such school of thoughts in Canada. *A fortiori* there is no such advocate in tax law. Canadian scholarship focuses on economics and tax policies rather than on economics and judicial decisions in tax law.

The second factor is the ability of the judiciary to analyse economic techniques and to ascertain their assumptions.[2] The resumes of the Supreme Court justices provide little evidence of formal training in economic theories.[3] None of them attended the University of Chicago. Most came from elite law schools in Canada and England, which taught law in the traditional manner.

However, this does not imply that the Supreme Court does not apply economic analysis in other areas of law. In the *Askov* case,[4] the court has conducted a detailed economic analysis of the Ontario court system in reaching its decision on a constitutional matter. The Supreme Court appears to give priority to constitutional cases over tax matters.[5]

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[1] Supra, Chapter IV, note 2.
[2] Supra, p.50.
[3] *The Supreme Court of Canada* (Ottawa: Minister of Supply and Services Canada, 1991).
[4] Supra, p.35.
[5] Supra, p.116.

In view of the present state of knowledge, the degree to which the Supreme Court takes economic reality into consideration seems to be logical: it avoids being dogmatic. Once the court enters into economic debates, as to the pros and cons of varying economic theories, the result will be uncertain at best and chaos at worst. It should be noted that the appointments of the leading legal scholars in law and economics to the Court of Appeal in the United States have been viewed to serve the economic objectives of former President Ronald Reagan.

The independence of the judiciary in Canadian tradition implies their independence from philosophical influence. If the advocates of law and economics have marketed their theories successfully in Canada, future judicial appointments are bound to be affected. Law and economics should be used as an analytical and research tool rather than as an implementation tool.

Table of Cases

A.L. Cox et al. v Attorney General of Canada [1988] 2 *C.T.C.* 365, 88 *D.T.C.* 6494 (S.C.C.)

Air Canada v British Columbia [1989] 1 *S.C.R.* 1161 (S.C.C.)

Alexander v Minister of National Revenue [1970] *Ex.C.R.* 138; [1969] *C.T.C.* 715 (Ex.)

Atlantic Sugar Refineries Ltd. v Minister of National Revenue [1948] *C.T.C.* 326, 4 *D.T.C.* 507 (Ex.)

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